

# C O R P O R A T I O N F I N A N C E

BY

HENRY E. HOAGLAND, Ph.D.

*Professor of Business Finance  
College of Commerce and Administration  
The Ohio State University*

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**TO  
JEMP**



## PREFACE TO THE THIRD EDITION

Conforming to custom, this is called a revision of a book first published more than a decade ago. In reality it is essentially a new book. All chapters have been changed materially. Indeed nearly all of them have been completely rewritten. New chapters have been added, containing material not presented in earlier editions. Some chapters have been eliminated, or their contents have been combined with others.

In the short space of time that has elapsed since the second edition was published, many changes have occurred that have had profound effect upon the financing of corporations. As a consequence, a mere revision of the material that was standard only a few years ago was not adequate to bring this text up to date. The contents of this edition include not only the facts about these changes but reflect the new environment in which business finance is now required to operate.

The first edition of this text pioneered in the field of corporation finance by including a section on social control. In this edition, this subject is dealt with throughout the book wherever it applies instead of depending solely upon dealing with it as if it were an appendage that might soon be amputated. If it ever were an appendage, it has now become absorbed in the body of the subject and must be dealt with realistically in many chapters. Business policies are still made in the board room, but only after they have been checked with the contents of laws and administrative orders set up to control and to regulate such policies. Wishful thinking is not likely to result in the elimination of these controls. Undoubtedly they will be changed from time to time; but over the years they are much more likely to expand rather than to contract. Whatever the interest of the reader in the field of corporation finance, a knowledge of these laws and administrative orders is essential to an understanding of current financial problems of American corporations. This revision makes a serious attempt to present the material needed for this purpose.

HENRY E. HOAGLAND

COLUMBUS, OHIO,  
*May, 1947.*



## PREFACE TO THE FIRST EDITION

This book has been written for the student—whether in the classroom, the library, or the office. It is not intended as a manual of detailed facts about specific business corporations. Instead it deals with the principles of corporation finance which underlie successful business management and successful investment. The book has been written in full recognition of the fact that few of its readers will ever become corporate directors and officers and that an even smaller number will ever undertake the promotion of business corporations. The author has had before him constantly the probability that most of his readers will, sooner or later, become owners of corporate securities.

Acknowledgment of indebtedness to all who, directly or indirectly, have contributed information is impracticable. The author's colleagues—William M. Duffus, Elvin F. Donaldson, Gilbert Harold, and N. Gilbert Riddle—all of whom have made helpful suggestions for the improvement of the manuscript, deserve special recognition. The author's assistant—Earl L. Knight—has aided in reading of proof.

HENRY E. HOAGLAND

COLUMBUS, OHIO,  
*April, 1933.*



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## INTRODUCTION

If you would appreciate the kind of world the American business corporation has helped to make available to you, first place yourself in the position occupied by your ancestors of a century ago. After adapting your economic thinking to theirs, return suddenly—as a stranger—to your world of today and marvel at the wonders you experience. What you are now accustomed to take for granted, because it is commonplace to you, would never cease to interest your ancestors who experienced a much simpler mode of living. Anyone who attempts to understand the economic changes that have taken place in this country during the past century must share this interest with your ancestors, had they the opportunity to witness these changes. The romance of industrial, commercial, and financial development during this period far transcends the manufactured romances that grace your library shelves. Writers of fiction find their real world so incomprehensible that they manufacture little make-believe worlds which are more easily manipulated.

Each of the goods and services that we daily enjoy appears to be fairly simple because we have never stopped to analyze them or to determine what we would do without them. Yet there is scarcely anything in our long list of necessities, conveniences, or luxuries that is not the unique product of the complex civilization of which we are a part. The aggregates of capital, made possible by the corporate form of enterprise, have in turn helped to produce our complex society: complex economically, politically, and socially. The watchwords of the early pioneers in this country were “freedom” and “independence.” Today we hope for as much freedom as our interdependence will allow.

The foreigner who attempts to analyze American civilization finds business a ruling force in our social life. No great political, educational, or religious effort is undertaken without consideration of its relation to our business institutions and ambitions. Few social programs of any importance have attained success during the past half century without enlisting the support of business leaders.

Tremendous resources, crying for exploitation by a selected group of individualistic immigrants, who came to America for the purpose of “getting ahead,” afforded a solid foundation for the erection of a philosophy of pragmatism which has sanctioned our social programs. The keystone of our pragmatic arch is the business corporation, whose development, both intensive and extensive, has been more marked here than in any other

country in the world. What appears to the European as the magic of American business can be explained by the efficiency expert in terms of daring experiments with machinery, methods, and policies—all for the purpose of finding the combination that works best.

The pioneering spirit, which prompts these experiments, we share perhaps with other peoples. But the tremendous scale of operations, made possible by large aggregates of capital available to American corporations, is peculiarly our own. Since success breeds success, our experience has prompted continuous trials producing ever new and startling developments.

The corporation is a symbol of capitalistic methods of production—of the construction and accumulation of specific equipment for the purpose of making human efforts more effective. Without it, the present state of industry and the arts in the United States is inconceivable.

Yet the corporation is not an American invention. Its roots strike back into the religious and political institutions of antiquity. Some of its branches flowered in Europe long before business became important in America. But the rich soil of natural resources, ambitious labor, and courageous management produced the greatest growth in this country. With encouragement from all quarters, it has been adapted to all forms of production, distribution, commerce, and finance, with the result that today investment opportunities are more and more being narrowed to the purchase of corporate securities.

The corporate form of conducting business enterprise should not be identified exclusively with big business. While it is true that big business is made possible by the use of corporate devices, it is also true that the corporate form is equally adaptable to small business units. In ever-widening circles, the advantages of incorporation have been extended to all classes of business and to all sizes of capital aggregations.

The corporation should not be looked upon as a finished device, sprung full-fledged from the brain of some legal or business genius. Instead, it is a product of evolution, still subject to changes as new conditions arise. At various times, serious efforts have been made to assign the parentage of American corporations to ancient religious bodies, to Roman municipalities, to early English guilds, or to various pre-American trading and shipping ventures. Probably to each of these, and to other similar associations, is due part of the credit, or the blame, for the corporation as it now exists. But more important than ancestry is the contemporary development that is taking place about us. Businessmen, lawyers, legislators, and all others interested in the corporate form of organization should recognize that the American business corporation is still in the making and can easily become what its sponsors wish it to be.

The corporation is all things to all people. The lawyer's interest does not parallel that of the accountant; the stockholder sees in it something that

may not exist for the legislator. The student of corporation finance must recognize and, in part at least, account for these varied and conflicting interests. He must, for instance, admit that the law plays a ruling part in the conduct of the financial affairs of business enterprises; but he must also admit that the law is merely the crystallized public opinion of the moment and is itself subject to change when such opinion demands new sanctions to meet new conditions. Even lawyers admit the fallibility of legal interpretations.

Law is what courts and partly irresponsible administrative agencies will do or say within the limits set by statutes and public opinion. . . . Some classify the events before them into categories determined by their training, their prejudices, their conscious or unconscious interests, their philosophy, their aesthetic leanings, or even by the chance circumstances surrounding the particular hearing.<sup>1</sup>

The Right Honorable Lord Macmillan expresses the same idea when he says:

Judges, as they often remind us, have to administer the law as they find it, but all the time they are themselves slowly shaping and developing it. In almost every case, except the very plainest, it would be possible to decide the issue either way, with reasonable legal justification.<sup>2</sup>

Unfortunate controversies that have arisen from time to time between accountants and other students of finance have been due largely to misunderstandings. Happily these are being eliminated as each group better understands the interests of the other. The so-called public interest in corporate affairs is a fact to be grappled with—not to be either ignored or condemned. Indeed, if the student of finance knows the truth, he will do well to use it to guide public opinion into proper channels of thought and action.

This volume is divided into seven parts.

Part I deals with the concept of the corporation. An attempt is made to give the reader a concise picture of this force, which plays such an important part in our business and economic life. The parties to the corporate contract are each dealt with briefly in the hope that their interrelationships may be clearly understood.

Part II defines the more common types of securities used in corporation finance. No attempt is made to discuss those rarely used types which play little part in the financing of American business. The classifications used are those most commonly employed in standard texts. Deviations from accepted practice are made when clarity and truthfulness seem to be served.

<sup>1</sup> Rodin, Max, *Legal Realism*, *Columbia Law Review*, May, 1931, p. 824.

<sup>2</sup> Quoted in Shientag, B. L., *A Modern Judicial Mind—The Writings of the Rt. Hon. Lord Macmillan*, *Columbia Law Review*, April, 1936, p. 626.

In Part III, the origin of corporations is pictured from the time of the conception of the idea to the disposition of the securities necessary to secure the capital with which the corporation may begin operations. The principles discussed herein apply equally to subsequent security issues. No attempt is made to deal exhaustively with those legal questions which affect finance only remotely.

Internal financial control is the subject of Part IV. Older texts on corporation finance confined their attention to a discussion of funds for the purchase of fixed capital, leaving circulating capital to texts on banking. Experience teaches us that no sharp line of distinction can be drawn between sources of funds for fixed capital and for circulating capital. To a considerable extent, they are linked together in such manner that an understanding of the former involves some knowledge of the latter. In this part of the book, therefore, attention will be given to those financial policies and practices which are commonly employed by corporations in their efforts to coordinate internal with external sources of capital funds. This part deals also with the determination of profits and with their disposition.

In large measure, the test of the importance of a business leader is the size of the corporation that he manages. At any rate, few American businessmen have been content to eke out a living from the profits of a small enterprise. The fact that many do so does not prove their contentment with their lot. Their ambitions at least speak for expansion. This subject is discussed in Part V. The reasons for expansion, the methods used, and the financial problems involved are discussed in turn.

What happens to the best laid plans is well known to all. Part VI deals with corporate disappointments and the salvage from the wreckage resulting therefrom. Someone has said that a corporation well organized and well managed will not fail. Perhaps so. We are attempting to deal with things as they are. Corporations do fail, and some of them are reconstructed. Their story is told in this part of the book.

Public interest and social control are elusive concepts. Nevertheless, they must be dealt with because the public is beginning to play a part in business operations that is apt to assume larger proportions in the future. Throughout this text the interest of the various "publics" concerned with corporation finance have been discussed. In addition, a summary of the problems of social control of corporations appears, together with proposals for their solution, in Part VII.

# PART I

## THE CORPORATE CONCEPT

### CHAPTER I

#### CAPITAL IN OUR ECONOMY

**Factors in Production.**—The three factors needed to produce and distribute the goods and services used in modern economic systems are capital, labor, and management. Disregarding the source of ownership of capital and the origin of its control, these three factors are necessary, irrespective of the type of economic organization present. Whether capitalism or communism—or some modification of either—is employed, there will still be need for the tools of production, or capital; for individuals to perform the tasks of production and distribution, or labor; and for those who direct the use of capital and labor, or management. Although it would be interesting to discuss the changing relationships of labor and management, the scope of a text on corporation finance confines our interest primarily to an analysis of the acquisition and the management of capital.

**Sterility of Savings.**—Capital results from savings. But mere saving may become a sterile act, working to the disadvantage of both the one who saves and the community. If the income receiver should hoard his savings, he would deny himself the current enjoyment of spending them. If he keeps such hoardings out of use by others, the community would suffer to the extent that the savings fail to produce. If, in addition, the hoardings become lost or are kept out of use indefinitely, the income receiver would have been practically as well off without them. It is only when savings are utilized in some form that sterility is avoided. Normally, we think of this utilization in terms of increasing the capital of the one who saves and, perhaps, of the community as well.

**Capital Concepts.**—The term “capital” is used in many ways so loosely that it is difficult to frame a consistent definition of it. At this point, we are interested in distinguishing between capital in the traditional economic sense and individual capital. The former consists of the total wealth used for productive purposes, or the accumulation of economic goods used or useful for the production of more goods and services. This definition makes no distinction between land and other capital. There is, of course, a difference between land and buildings. But there is also a difference between

buildings and other kinds of capital. For our purposes, it appears better to adhere to the above stated definition. From this point of view, ownership of capital is not so essential as its use. Ownership might change hands frequently without in any manner influencing the use to which the capital is put. Even collective ownership would not change the concept of capital as economic goods used or useful in producing more goods and services.

To an increasing extent, individual capital consists chiefly of the possession of evidences of ownership of economic capital. The individual capitalist may own no land, buildings, equipment, inventory, or any other type of economic goods, as defined in the preceding paragraph. Instead, he may own stocks, bonds, or other evidence of claims against property or individuals. Indeed, individual capital is not confined to evidence of ownership of economic capital. If *A* possesses savings, he may transfer their possession and use to *B* who wishes to use them for productive purposes, or to *C* who desires to purchase consumption goods. In either event, let us assume that *A* receives in return for the use of his savings an interest-bearing promissory note. This note constitutes a part of *A*'s capital. Except as otherwise indicated, we shall be concerned in this chapter with economic rather than with individual capital.

**Capitalistic Economy.**—Without stopping to weigh the merits of private vs. public ownership of the tools of production, we must assume in this text that we are concerned primarily with the former. We say primarily because, even in a capitalistic economy, we find increasing evidence of public ownership of some kinds of capital. An industry which we recognize as sufficiently affected with a public interest sooner or later looks to the public for financing its operations. Such financing may be permanent, as in the case of publicly owned utilities, or it may be temporary, as in the case of government-financed production facilities to meet the needs of a war economy. In both cases, however, private and public finance may be involved. Private individuals may own the bonds issued by a publicly managed utility. Private management may merge privately owned capital with that financed by governmental agencies in wartime.

It is customary for critics of the capitalistic system as such to accuse owners of capital of exploitation in its accumulation. To such critics, capital results from applying labor to resources in such manner that more efficient tools of production are accumulated. But there must be something more than labor and resources before capital is created. In great areas of the world both manpower and resources exist in abundance without the presence of either the ability or the willingness to combine them into new forms that merit the name capital. There is, therefore, a psychological as well as a material connotation to the term capital.

**Sources of Capital.**—Much has been written to account for the payment of interest and dividends to the owners of capital goods. In most of these

discussions, the theory of abstinence plays a leading role. By this is meant that those who save abstain from spending all their current income in order to obtain greater satisfaction from future expenditures. Not infrequently, there is an implication that the self-denial or self-restraint practiced by the one who saves is at the expense of his present well-being. Saving is assumed to produce some kind of mental pain. In any event, abstinence is significant in accounting for that part of capital which individuals provide through their own free will. In addition, a large and growing amount of privately owned capital is accumulated collectively in the form of undistributed profits of corporations and of other types of business enterprises.

For example, during the period from 1921 to 1938, the United States Steel Corp. incurred capital expenditures of one and a quarter billion dollars, most of which was financed by depreciation allowances and undistributed earnings. During the same period, General Motors Corp. expended over \$1 billion for plant and equipment, financed largely by retained profits and depreciation allowances. Even railroads financed a considerable proportion of their capital expenditures during this period from undistributed earnings.<sup>1</sup>

In such cases the individual owner of stocks and bonds has little or no choice in keeping his money invested and no voice in determining the amount of new capital to be so created. Hence the theory of abstinence, at least as it is usually understood, can hardly apply directly to corporate savings. In the third place, that part of capital goods which is publicly owned is usually, at least in the first instance, taken from individuals and groups in the form of taxation. In a very indirect sense perhaps, this too can be classed as abstinence since, in a democracy, the representative consent of the taxpayers is necessary before they can be taxed.

A sample of the amount of corporate savings is shown in the table on page 8 for the year 1937. Savings in this table "equals compiled net profits, minus income and excess profits taxes and cash dividends paid, plus depreciation and depletion."<sup>2</sup>

**Individual Savings.**—Individuals may be divided into classes with respect to their savings experience. A sizable proportion of income receivers save little or nothing. In fact, many people are dissavers; they spend more than they earn. Even those who are entirely self-supporting frequently save nothing. In some cases their income is so small that all of it is needed to pay for current necessities. In other cases, where something could be saved, current desires for conveniences and luxuries outweigh the consideration of possible future needs so that nothing is saved. A second sizable group look upon saving as deferred spending. The members of this group abstain from the satisfaction of a part of their current desires in order that

<sup>1</sup> "Investment Trusts and Investment Companies," Report of the Securities and Exchange Commission, Part V, p. 341, Washington, 1942.

<sup>2</sup> Koch, A. R., "The Financing of Large Corporations" (New York, 1943), p. 79.

GROSS SAVINGS OF ALL NONFINANCIAL CORPORATIONS, 1937, BY SIZE OF CORPORATION  
(Dollar amounts in billions)

Size	Num- ber	Total assets	Gross savings	Percentage Distribution		
				Num- ber	Total assets	Gross savings
Small (under \$500 thousand) . . . . .	294,297	\$20	\$0.2	92.4	12.0	7.0
Medium-sized (\$500 thousand-\$10 million) . . . . .	22,491	38	0.9	7.1	23.0	31.0
Large (\$10 million and over) . . . . .	1,676	105	1.8	0.5	65.0	62.0
Total . . . . .	318,464	\$163	\$2.9	100.0	100.0	100.0

they may be assured of having something to spend at a future time. Some save for specific purposes: such as the purchase of an automobile or a home, or the payment of the costs of educating their children. Others merely save something for the proverbial rainy day which may arrive without warning. Still a third class—smaller than either of the other two—save because their current incomes exceed their requirements to satisfy their total desires for necessities, conveniences, and luxuries. While the term “abstinence” can be applied to the savings of this group, it certainly carries no connotation of mental pain or physical discomfort. Indeed, many members of both the second and third classes would suffer mental discomfort from spending all that they earn. A great many people save through habit. They deny themselves current luxuries, conveniences, and perhaps even some necessities in order to add to their hoards. Such people are likely to save what their heirs spend.

**Forced Savings.**—Under unusual circumstances, individuals who normally do not save may be forced to do so. For example, during the Second World War, a great many people accumulated savings, particularly in the form of war bonds. Two reasons accounted for this kind of saving. (1) It was considered unpatriotic not to buy war bonds. Through pay-roll deductions and by other means, there was an element of coercion in many saving programs. (2) The scarcity of goods made it difficult for consumers to satisfy their wants, even though they had money to spend. Some of those who were induced to save during the war period will become consistent savers in the postwar period; others of this class cash their war bonds at the first opportunity.

**Amount of Individual Savings.**—The *Survey of Current Business* for January, 1946, shows the following amounts of individual net savings for the years 1939 to 1945 (in billions of dollars): 1939, 6.0; 1940, 7.3; 1941, 14.2; 1942, 28.6; 1943, 33.3; 1944, 38.9; 1945, 35.3.



According to the results of a survey conducted by the Bureau of Agricultural Economics, at the request of the board of governors of the Federal Reserve system, in 1945, 10 per cent of income producers owned 53 per cent of gross savings, 40 per cent owned 44 per cent of savings, and the bottom 50 per cent owned only 3 per cent of the savings. When these figures are adjusted for dissavings—expenditures in excess of income—the results are as follows: the upper 10 per cent of income producers owned 60 per cent of the net savings, the middle 40 per cent owned 51 per cent of the net savings, and the bottom 50 per cent were charged with dissavings of 11 per cent.

**Savings Environment.**—Two sets of conditions are essential to create a satisfactory savings environment—one positive and the other negative. On the positive side, there must be present a feeling of political and economic stability. Where there is lack of confidence in either, there is less incentive to save. If income receivers doubt the continued stability of the value of their dollars, there is more likelihood that present expenditures will absorb a larger part of current receipts. On the negative side, the income receivers must not place too much confidence in the capacity and the willingness of others, including their government, to care for their future needs. To the extent that people are led to believe that a benevolent government will finance all their needs, from the cradle to the grave, there will be less incentive for individual savings.

**Investment of Savings.**—Those who save a part of their current income normally face the problem of investing their savings in a manner that will meet their requirements. These requirements, varying in degree with different individuals, include safety, return, and availability. Some prefer to sacrifice return for safety and availability. Others are attracted by promises of a high return and are willing to sacrifice safety if need be to try to get the promised return. If the amount of savings owned by any individual is large enough, a part may be invested where it is very safe, a part may take the risks that go with the promise of a high return, and a part may be kept in liquid form to afford maximum availability when needed. The owner of only a small amount of savings has no such opportunity and may be forced to choose among the requirements he expects of his savings.

**Investment Outlets.**—In exercising his choices, the owner of savings has essentially four alternatives: (1) he may purchase government bonds, where the elements of safety and availability are relatively high but where the return is correspondingly low; (2) he may deposit his savings in a financial institution, thereby shifting to it the responsibility for choosing the kind of investment to make; (3) he may choose to purchase corporate securities, where he has opportunities to select any kind, from those which are highly speculative to those which are as safe as any investment can be; or (4) if he is the unusual individual who possesses business ability and ambition

beyond mere investment, he may undertake the establishment of a business of his own. Again the large investor has presented to him the possibility of a balanced program, utilizing several of the outlets mentioned above. The small investor is much more limited in his choices.

**Scope of Investment Markets.**—On the side of demand for investment funds, there is a wide divergence in the geographical scope of investment markets. Some stocks and bonds enjoy a national and indeed an international market. In addition to their favorable market reception, based upon their satisfactory past experience, security exchanges facilitate their purchase and sale. As a consequence of the favor in which they are held, the corporations that issued them can usually consummate additional financing at relatively low cost. At the other extreme, some securities lack even a local market. A new and untried enterprise may be seriously handicapped because of the absence of financial support. Probably small investors should hesitate to take the chances that accompany commitments to small and unseasoned business enterprises. Large investors may not become interested in them so readily as in the securities of better known corporations.

**Number of Business Enterprises.**—There are roughly 3,500,000 business enterprises in the United States, divided as follows, on the basis of their type of organization: proprietorships, 70 per cent; corporations, 20 per cent; and partnerships, 10 per cent. However, the lion's share of American business is done by corporations. Those with total assets of more than \$5,000,000 each constitute about 1 per cent of all corporations; yet they are responsible for about half of the total volume of business done in this country.<sup>1</sup> The reasons for this concentration of business volume in many lines of business are obvious. Modern industrial, commercial, and financial processes involve large aggregates of capital. A single steel-rolling and finishing mill may involve an investment of \$60,000,000. Du Pont's original investment in a plant to produce nylon exceeded \$8,000,000.<sup>2</sup>

**New Units.**—New business enterprises are established in this country at the rate of more than 1,000 per day. Probably more than 400,000 were started in 1940 alone. Of these, probably less than half were definitely new business units, while the remainder were successions with varying degrees of newness. In addition, there were an undetermined number of extensions, representing geographic and commodity expansion. The rate of establishment of new enterprises in proportion to the number in existence is smaller than it was some years ago. In 1925, approximately 24 new business units were started for every 100 in existence; by 1940 the proportion had declined to 18 per 100, a drop of 25 per cent. The severity of the depression of the 1930's, with the loss of savings for potential entrepreneurs,

<sup>1</sup> Koch, *op. cit.*, p. 9.

<sup>2</sup> *Ibid.*

and the rising taxes on business activity were potent factors in this decline.<sup>1</sup> A large majority of all new firms are small retailers.

Meantime, the number of business firms that discontinue operations each year approximate the number of new firms that are formed. In the opinion of one writer, the number of firms that quit business in the 10 years from 1935 to 1944 exceeded the number organized during the same period.<sup>2</sup>

It has been estimated that one gainfully employed person in fifteen at some time in his life starts in business for himself. Several reasons account for this type of venture. Since finance is the determining factor in many cases, it is not unusual for the person who inherits, saves, receives by gift, marries, or is able to borrow enough to establish a business to give it a trial. Not all who engage in a business venture of their own hope for a financial advantage. Some are motivated by the desire for freedom from domination by others and by the higher social status enjoyed by a "businessman" in comparison with the man who is employed. As a matter of fact, of those who enjoy a measure of success in business operation, few provide much more than a living for their owner-operators. Since this is the major objective in many instances, a profit on the invested capital is of secondary importance.<sup>3</sup> Dissatisfaction with employment conditions frequently results in the establishment of new business units. The discovery of what appears to be promising opportunities for profit accounts for the establishment of many enterprises. Even the hope of escaping from unemployment results in the starting of new business units.

The capital needed to start new business enterprises varies with the nature of the business and the scope of operations undertaken. The most common sources of new capital funds are as follows: The accumulations of the owner constitute the largest proportion, probably accounting for more than half of all initial capital. Loans from friends and relatives rank second in importance. Such loans are not generally considered to be strict business ventures. The desire to help a friend or relative get started overweighs the careful analysis of the risks involved. Except for such loans, which may be indefinite as to maturity, new small enterprises seldom acquire long-term debts, at least at the outset. Such as are incurred are likely to be in the form of mortgages on real estate. Next in order are the sources of capital whose contributors hope to receive an advantage by their advances to new enterprises. These include wholesalers, jobbers, and manufacturers who extend trade credit and the sellers of fixtures and equipment on some kind of an installment plan.

<sup>1</sup> Oxenfeldt, A. R., "New Firms and Free Enterprise" (Washington, 1943), pp. 34-37 and 182.

<sup>2</sup> Foulke, R. A., "Practical Financial Statement Analysis" (New York, 1945), p. 148 *n*.

<sup>3</sup> Merwin, C. L., "Financing Small Corporations" (New York, 1942), pp. 2-3.

Banks play a minor part in the financing of new enterprises. Occasionally an insurance company may help to furnish capital in the form of a policy loan. This means that the capital needs of small new enterprises are being met chiefly by equity capital, "friendship" loans, and short-term financing.

**Financial Problems of Small Business Enterprises.**—As a consequence, small business enterprises face serious problems in seeking financial aid—problems that are relatively more difficult to solve than are those of larger and more seasoned enterprises. This difficulty is well illustrated by the experience of small and unseasoned enterprises which registered securities for sale under the Securities Act of 1933. During the first seven years, 1933 to 1939, such issues amounted to approximately \$185,000,000. Of this total, only \$52,000,000, or 28 per cent, were sold within 12 months after the first offer. About 36 per cent of the issuers, with 40 per cent of the registered preferred and common stock, were unable to sell any of their stock. Of those issuers which were able to sell some part of their offerings, sales averaged 53 per cent of offerings.<sup>1</sup> At least three factors account for this lack of success: (1) The period covered was one in which capital was timid and its owners hesitated to make any uncertain commitments. (2) Most of the issuers lacked the services of investment bankers and security dealers, who do not handle unseasoned securities. (3) Investors were reluctant to purchase the kind of securities offered.

There is no organized opposition to the financing of small business enterprises in this country. On the contrary, there is a general recognition of the desirability of encouraging small new enterprises. Everyone recognizes that, before a business can become seasoned, it must experience a period of incubation and, if possible, growth. All are sympathetic to the idea that economic progress results only from trying out new ideas—usually on a small scale first. But, because the idea is new, it may be impractical. There is only one sure way to determine this test, and that is by trial. Our experience records many more failures than successes. The death rate among new enterprises is exceedingly high.

**Kinds of Capital Needed.**—Most business units need both equity capital and borrowed funds. For small business enterprises, both are relatively scarce and costly. The disinterested individual who possesses an investable surplus of funds is loath to commit any part of it to a new untried business enterprise in the purchase of its equity securities. The classic exception is the sale by the Kaiser-Fraser Corp. of millions of dollars worth of common stock before this firm ever had a product on general display. The financial institution with money to lend hesitates to risk its trusteed funds where the chances of recovery are difficult to estimate. Lending institutions are especially hesitant to make loans where the equity of the owners is small. In such cases the lender is, in effect, assuming the primary

<sup>1</sup> "Investment Trusts and Investment Companies," *op. cit.*, pp. 344-345.

risks of the enterpriser instead of those of a lender. These are not new phenomena. They have obtained for a long time. Nevertheless, there has been much recent discussion of a nature to permit the inference that small business enterprises have been subjected recently to peculiar handicaps in obtaining financial assistance.

**Organized Markets.**—As indicated above, the financial markets are normally organized to serve the seasoned business enterprises. It is not unusual for a security exchange to require a distribution of ownership and an earnings experience as prerequisites to the use of its facilities by any business enterprise. This means that such markets are closed to the untried and unseasoned business unit. It is unlikely that any amount of exhortation by interested parties will effect fundamental changes in these practices. Instead, it should be apparent that a new and different kind of financial market will be needed to provide assistance for small business units. For the most part, existing financial markets are organized on the assumption that each individual security purchaser understands the nature and weighs the amount of the risk that he assumes when he makes a commitment of his funds. At least he is shouldered with this responsibility, whether he understands the implications of it or not.

**Sharing the Risks.**—Because of the importance of encouraging new enterprises, in order that we may enjoy their fruits and create more employment by this means, it appears that, where the risks of failure are too great for individuals to assume, we should seek a means of pooling them. Examples of this type of financial organization are not lacking. Most financial institutions that reinvest the funds entrusted to their care face problems of pooling of financial risks. This may be done at various levels. To date, there is no adequate means of providing equity capital for new enterprises by the use of pooling devices. Experiments are being tried by commercial banks in pooling the risks of providing small business units with borrowed capital. Where a single bank may hesitate to make the loans needed by small business units, several banks may spread the risk by making collective loans. If a small business enterprise needs to borrow \$50,000, each of five banks may advance \$10,000 to it. Five such investments in five separate business enterprises would probably be less risky for the lender than a single loan of \$50,000 to a single business unit. If this plan succeeds, perhaps some additional pioneering can be induced to provide equity capital by similar means. Certainly many not too intelligent or well-informed investors would take less chances in pooling their commitments than they take in their hit-and-miss purchases at present.

**Cooperative Experiments.**—There are already in operation some illustrations of cooperative efforts to finance small business units. The New England Industrial Development Corp. has interested bankers, industrial leaders, attorneys, and others in helping to finance small business enterprises

in that area. If a preliminary investigation of an application for financial assistance produces favorable results, a fee is charged the applicant for the services of accountants, engineers, and whatever other expert assistance is needed, to enable the directors of the corporation to reach a decision concerning the application. If the results of this study seem to justify the application, financial assistance is extended in whatever form seems to meet the circumstances most satisfactorily. It is not unusual for the corporation to take preferred stock—with a bonus of common—to evidence its participation in the venture. In addition to financial assistance, the corporation places at the disposal of the enterprise the advice of experienced managers and technical experts in helping to solve the problems of the business.

Similar organizations for the financing of small business enterprises are the Wyoming Valley Industrial Development Fund, which operates in and near Wilkes-Barre, Pa., and the Louisville Industrial Foundation of Louisville, Ky. The latter has invested approximately \$4,000,000 in local enterprises over a period of 30 years. In later years, it has confined its financial assistance to loans and secured advances.<sup>1</sup> Still another effort to assist small business was started a quarter of a century ago by leading industrial, commercial, and financial institutions of Baltimore, Md. In the hope of attracting new industries and providing employment for more people by encouraging existing struggling business enterprises, the Industrial Corporation of Baltimore was formed. A free preliminary checkup is made where assistance seems to be needed. This is followed by a more thorough investigation where preliminary results are encouraging. A fee is charged for this second investigation. It may prove that what is needed is something other than financial assistance. This corporation was started with the idea of rendering financial assistance as needed; but for most of its life it has acted more in the capacity of financial and business adviser to both new and old enterprises within the area in which it operates.

**Government Guarantees.**—Another method of pooling the risks of financing small business units that has been seriously proposed in many quarters in recent years is the guarantee of such financing by the Federal government. Our experience in attaching such guarantees to various kinds of financial operations during the past few years—in the form of insurance of bank deposits, the investment of funds in savings and loan associations, and of mortgages on residential real estate—has led to the suggestion of a government guarantee of financial assistance to small business enterprises. Some suggestions provide for the guarantee of loans only, assuming the existence of an equity to protect the lender and the government, while others go so far as to recommend governmental guarantee of what amounts to equity capital. It should be noted that every business venture

<sup>1</sup> Weissman, R. L., "Small Business and Venture Capital" (New York, 1945), pp. 49ff.

involves not only the economical use of available finances, but also the general integrity and competence of the management as well. In any plan to add the government's guarantee to the financial arrangements of a business enterprise, the tests of integrity and competence appear to be of primary importance. To date, we have not devised adequate means of measuring either.

**GI Business Loans.**—A grateful government has made provision in the GI Bill of Rights to guarantee loans for business purposes to returned veterans of the Second World War. On the theory that many veterans would prefer to establish business enterprises of their own instead of accepting employment from others, the government has made liberal plans to guarantee loans by private financial institutions to veterans for this purpose. Certainly all would accept this group of borrowers as worthy of this test. It will be a matter of general interest to watch the results. All competent observers expect many failures to follow the use of government guarantees of GI loans for business purposes. Our final judgment should be based upon the measure of gain compared with the amount of loss involved. The net results of this program should provide us with some of the answers we need before embarking upon a general plan of government guarantees of financial assistance to small business units.

**Politics of Small Business.**—The unanimity of support for the lending features of the GI Bill of Rights in both houses of Congress demonstrates the political appeal of support for the largest potential political bloc in the postwar period. There are other evidences that the emotional background of belief in the virtues of small business as such has a political foreground as well. During the Second World War, each house of Congress had a special small-business committee. Hundreds of bills have been introduced in Congress in recent years, each for the purpose of giving special favors to small business units. As a means of encouraging participation in war contracts by small business units, there was created the Smaller War Plants Corporation. In the Department of Commerce, a special section was organized to foster and promote small business. Throughout our history there have been attempts to unite farmers, wage earners, and small businessmen into one political bloc. A great many Americans have an abiding faith in the virtues of small size. They are opposed to bigness, whether in business or in government.

**Patterns Already Established.**—Innovations in finance created during recent years have established patterns that may be followed in the financing of small business units. For example, the Home Owners Loan Corp., created by law in 1933, made loans on more than a million homes of distressed owners. Starting with an initial capital of \$200,000,000, subscribed in the form of stock purchase by the Reconstruction Finance

Corporation, it received from Congress bond-issuing authority which eventually amounted to \$4,750,000,000. Not all this was used by the H.O.L.C. The repayment of these bonds and the interest thereon is guaranteed by the United States. At the time the law was passed, many observers felt that the loss of a few hundred million dollars by this corporation would be cheap payment for saving the homes of borrowers unable to refinance their distressed loans. It appears at this writing that eventually no loss will be suffered by this corporation. However, caution should be observed in attempting to draw too close a parallel between the financing of tangible real estate used for residential purposes, which can be appraised by more or less standard rules, and the financing of miscellaneous small business enterprises, which, by definition, are almost always incapable of accurate appraisal until they have been put to the acid test of experience.

The R.F.C.'s experience with the financing of small business enterprises is not too illuminating. In general, two policies were followed by the R.F.C. in granting small loans. Some loans were made where it was not expected that even the principal would be repaid. These were of the type where floods or other catastrophes made a contribution by a governmental agency seem desirable, as a means of encouraging rehabilitation of business enterprises after severe losses. For the most part, small loans offered by the R.F.C., except under the above circumstances, required such security as to recommend that the borrower seek other means of financing instead. Those in a position to exercise responsibility for granting R.F.C. loans were inclined to use the same kind of judgment that prudent lenders would normally use. As a consequence, the small-loan experience of the R.F.C. was not nearly so extensive as the financing of larger business units.

**Proposal for Industrial Loan Corporation.**—Among numerous bills introduced into Congress in recent years, having for their objective the lending of Federal assistance in the financing of small business, was the Mead bill, introduced first in the First Session of the Seventy-sixth Congress. It proposed to amend Section 13b of the Federal Reserve Act to create an Industrial Loan Corporation, empowered to invest government funds in the preferred stock, bonds, notes, and other obligations of industrial and commercial enterprises. Such investment could be made directly or in cooperation with other financial institutions. Not more than \$1,000,000 could be invested in any business enterprise. In addition to its capital fund of \$139,000,000, the corporation was to be permitted to issue additional securities to an aggregate of one half billion dollars and to borrow from Federal Reserve banks. This bill was still under consideration by the Seventy-ninth Congress without receiving enough support to ensure its passage into law.



**Federal Reserve Investment Corporation.**—A similar proposal<sup>1</sup> would create, within the Federal Reserve system, a quasi-public corporation for the purpose of financing small business. Its stock would be owned by the commercial member banks of the Federal Reserve system, but its general supervision would be vested in the board of governors of the system. It would have regional offices as needed, each to be managed by a board of directors whose selection would be patterned after those of Federal Reserve banks. The corporation would be empowered to make loans to and to purchase preferred stock from small business enterprises and to assist such businesses by the use of the service of managers and technical experts employed by the corporation. This proposal, like the preceding one, is still in the planning stage.

**Statistics of Small Business.**—There is no commonly accepted definition of "small" business. Naturally a small railroad would be measured by different yardsticks than would be used in measuring a small retail establishment. The elements that commonly enter into our concept of small business include personal management by the owner and a scope of operations that can easily be characterized as local. The definitions of small business adopted by the Bureau of Foreign and Domestic Commerce are as follows: manufacturing plants with 100 employees or less; wholesale establishments with annual net sales of less than \$200,000; and retail stores, service agencies, construction companies, places of amusement, etc., with net sales or receipts of less than \$50,000 per year. Using these definitions, the 1939 census of manufactures and business showed the following percentages of small business units to the total of all business units for the United States:

RATIO OF SMALL BUSINESS UNITS TO TOTAL IN THE UNITED STATES, 1939

(Per cent small to total)

	Number of establishments	Total employees	Total value of product
Manufacturing . . . . .	92	30	31
Wholesaling . . . . .	77	39	21
Retailing . . . . .	91	56	42
Service . . . . .	99	74	66
Hotels . . . . .	90	31	27
Construction . . . . .	93	47	34
Amusement . . . . .	90	57	33
Total . . . . .	93	45	34

<sup>1</sup> Weissman, *op. cit.*, pp. 88ff.

Although small units accounted for 93 per cent of the total number of units, they employed only 45 per cent of the total number of employees and produced only 34 per cent of the total value of the product. In manufacturing, small units accounted for 92 per cent in number, but only 30 per cent of employees and 31 per cent of the product. The foregoing table does not include about 6,000,000 farmers who may be considered small business operators. Over the years, the tendency has been to record an increasing proportion of the total business done in this country for the larger business units.

Of 1,855,000 active commercial and industrial enterprises listed by Dun & Bradstreet, Inc. in its July, 1944, *Reference Book of the Mercantile Agency*, the percentage distribution, according to tangible net worth, was as follows:<sup>1</sup>

Tangible Net Worth	Percentage Distribution
Under \$1,000 .....	41.5
1,000-3,000 .....	20.7
3,000-5,000 .....	11.1
5,000-10,000 .....	10.2
10,000-20,000 .....	6.8
20,000-50,000 .....	5.3
50,000-200,000 .....	3.1
200,000-1,000,000 .....	0.9
Over 1,000,000 .....	0.4

According to this classification, 83.5 per cent of all active commercial and industrial enterprises have tangible net worth of \$10,000 or less; and 95.6 per cent have tangible net worth of \$50,000 or less. Approximately 80 per cent of all firms included in the above figures are retailers.

**Increasing Use of Capital.**—With the increase in the size of the business unit, there is a corresponding increase in the amount of capital needed per employee. A capitalistic society tends to become more capitalistic—to place increasing emphasis upon the use of capital and to depend upon this capital to perform a part of the tasks formerly cared for by human beings. According to the latest available information, an investment of \$25,000 per employee is required in the steel business and in railroad transportation, \$6,300 is the average in manufacturing, and \$5,000 or less in retailing. Since the end of business enterprise is consumption—with production only a means—it is evident that new business enterprises must constantly be created to employ our ever increasing population.

**Other Uses for Savings.**—Mention has already been made of public uses for savings. Since this subject is beyond the scope of a treatise on corporation finance, except perhaps where publicly managed corporations compete with private business, no attempt is made here to deal fully with

<sup>1</sup> Foulke, *op. cit.*, p. 147.

such use. Likewise, certain private uses of savings that emphasize consumption rather than production are not included in this discussion. For example, billions of dollars are used to finance durable consumption goods, such as homes. Here a variety of motives direct the investment of savings, perhaps few of which could be associated directly with the desire for profits. We are not content to meet the elemental demands for shelter; but we invest our savings in homes for the purpose of providing comfort and of establishing our status in the community. Prestige, the approbation of our neighbors, the establishment of a measure of achievement, and other nonprofit motives dominate our decisions in the use of our savings.

**Changing Character of Capital Demand.**—One of the distinguishing characteristics of an economy dominated by private enterprise is the constant shifting of demand for capital. Whole eras in our brief history have been named for the industry that became dominant at the time. We speak of the railroad-building era of the past century, when tremendous amounts of foreign capital were used to build our transportation network. After the turn of the present century, the automobile business absorbed the lion's share of new capital in the construction and equipment of factories and in developing distribution and servicing facilities. Concurrently, the demand for better roads to accommodate the millions of automobiles created general uses of public capital in their construction and reconstruction.

Meantime, there is another side to this picture. Whole industries have disappeared because of their inability to hold the favor of a fickle public demand. At one time it was possible to travel from St. Louis to Boston over the lines of interurban railroads. Now it would be difficult to find even local examples of what was once a national service agency. Before the Second World War revived the rapidly declining fortunes of steam railroads there were serious questions raised about their ability to compete with trucks, busses, private automobiles, and airplanes. Some of these questions have not been finally answered.

**Significance of Capital in Corporation Finance.**—Corporation finance deals primarily with the acquisition and the use of capital by business corporations. Since the corporate form of business organization is used by small, medium-sized, and large business units, the chapters that follow undertake to deal with the principles of corporation finance, regardless of the size of the business unit involved. It is necessary to cite the better known corporations in much of the illustrative material of the text. This material is available in the literature of business finance. The smallest, least well-known business units seldom have their operations discussed in a manner that makes the use of their experience public property. Even if such experiences were available, however, it is doubtful

if they would add much to the principles discussed in the following chapters.

### QUESTIONS AND SUGGESTIONS

1. Who supplies capital and management in a communistic society?
2. Does the total capital of all individuals in this country equal the value of the nation's productive capital? Explain.
3. Is public ownership of capital increasing or decreasing in this country? Give examples.
4. Give illustrations of capital accumulations that represent real abstinence and those that do not.
5. What can an individual gain by saving? What can he lose? Are you a saver or a dissaver?
6. Give an illustration of a current public policy favorable to savings environment. One that is unfavorable.
7. What conditions help to determine the investment requirements of different individuals?
8. Give illustrations of kinds of business that require a great deal of capital. Of those that require but little.
9. Are the statistics of new business units and of business failures entirely correct? Explain.
10. Why are new business units organized?
11. State, in the order of importance, the sources of capital for new business ventures.
12. Do you favor the encouragement of new business enterprises? Why?
13. Is it easier for small or large business units to obtain financial assistance from organized financial markets? Why?
14. Explain what is meant by sharing the risks, and show how it is done.
15. What is the New England Industrial Development Corp., and how does it function?
16. State the pros and cons of government guarantees of loans to small business enterprises.
17. What has been the experience to date with the financing of GI business loans? What does it prove?
18. Contrast the operation of the H.O.L.C. with government guarantees of the financing of small business ventures.
19. Summarize and appraise the Mead bill for financing small business units.
20. What conclusions do you draw from the table showing the ratio of small business units to the total in the United States?
21. Should we devote more or less savings to capital purposes? State the arguments on each side of this question.
22. What industries are likely to demand less and what ones more outside capital in the future than in the past?
23. Does the disappearance of an industry result in a social gain or a loss? Explain.

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## CHAPTER II

### EVOLUTION OF THE CORPORATION

**Types of Business Organization.**—The business corporation exists side by side with its contemporary ancestors. All its predecessors are still to be found in present-day use. While the tendency is unmistakably in the direction of the ever-widening use of the corporation, there are still sets of circumstances that suggest the use of simpler forms of business organization. A brief review of these other forms will serve two purposes: (1) it will help the student to understand the process of evolution of the modern corporation; and (2) it will show, by contrast, the advantages enjoyed by the corporation.

In selecting the form of organization for a particular business enterprise, we must not assume that strict logic always dictates the decision. On the contrary, in many instances some other form than the one selected would undoubtedly serve the purpose better. The frequent changes made in the type of control suggest the recognition of a superior form. Some of these changes represent the results of an evolutionary process, while others appear to be just afterthoughts. The fact that nearly all the changes are in the direction of incorporating simpler forms probably signifies the superior advantages of the former.

**Legal Limitations.**—Since society is made up of many individuals, we must live together according to the rules established for our common good. These rules consist of laws that have gained common acceptance. For the most part, our actions are governed by common law which is the crystallized custom of the times. It is probable that we could get along fairly well in our relations with each other if we merely lived up to the accepted standards of the group. Occasionally we are forced to ask our courts for an interpretation of the meaning of common law. Hence we sometimes speak of it as "judge-made" law. Such a designation is not quite accurate, since the judge is the interpreter of accepted customs and not the legislator who initiates the rules of the game.

Most business practices are governed by common law. Even some forms of business enterprise are merely the consequences of accepted practices. They are not the products of legislative action. That is why they are frequently designated as "common-law" business enterprises. In general, it may be said that the common law best serves a system of economic organization of society where human relationships are simple and

may be determined by direct contact between the interested parties. Where changes occur rapidly or where human relationships become too complex, the scope of the common law, flexible though it be, becomes inadequate to cope with the new conditions.

This inadequacy of the common law results in the passage of specific statutes by legislative bodies, intended to govern specified kinds of situations. For the most part, statutory law is expected to clarify common law where there is doubt or conflict in its interpretation; to modify it where changes are necessary to enable it to meet the needs of a progressive economic system; or to nullify it if the changes are so drastic that a new and different set of practices is required. Where common law and statute law are in conflict, the latter is supreme. In some instances, statute law deals with questions not contemplated in the common law.

Within recent years, still another type of law affecting rules of business conduct has become very common. Bewildered in their attempts to establish detailed statutes to handle the specific problems of modern human relationships, legislative bodies have delegated to administrative boards a considerable measure of their lawmaking authority. By establishing in the statute the objectives to be sought, the legislatures have then turned over to boards and commissions the responsibility for writing the rules and regulations necessary to attain these objectives. Such administrative bodies frequently assume authority that is not only legislative and executive in character, but judicial as well. Their future relationship to business enterprise bids fair to be very far reaching.

Throughout this study, the impact of the various forms of the law upon business control will become apparent. As will be shown presently, the corporation, particularly, is governed by legal rules much more directly than are some of the simpler types of business organization.

**Individual Proprietorship.**—The earliest and still the simplest form of business organization is the individual, or sole, proprietorship. In it we find the epitome of the meaning of individual initiative. Any individual with access to sufficient capital to serve his purposes may start in business "on his own." In reaching this conclusion, the individual is required to consult no one. Within the limits of his own capacity, he may conduct his business as he sees fit, subject only to his respect for the correlative legal rights of others. Should the proprietor decide to change his products or processes or in any other manner to redirect his energies, such decision also is a question for him alone to answer.

In assuming the authority of an individual proprietor, corresponding responsibility must be accepted. This includes particularly the question of full liability for his acts. With unimportant exceptions, which we need not stop to discuss here, all of the assets of the owner of the business are pledged to its success or failure. This unlimited liability constitutes,

perhaps, the outstanding reason why business enterprises that attain any considerable size and develop important obligations to others hesitate to operate as individual proprietorships. In addition, certain other disabilities are suffered by this simple form of business enterprise.

In general, the amount of capital that it may command and hence the scope of its operations are distinctly limited by the assets and the credit standing of the sole proprietor. The amount of credit available to him is a function of his personal capital, plus certain intangibles which attach to his status. For example, the flexibility of this type of business enterprise may become a source of weakness as well as of strength. The death or disability of the proprietor might easily result in the dissolution of the business under conditions that would affect the creditors adversely.

**General Partnership.**—Probably next in order after the individual proprietorship we find the development of the general partnership. Since its origin is shrouded in the mists of antiquity, we can only conjecture the nature of its beginnings. It is likely that a father, wishing to train his son in the ways of his business or, being obligated to find means of a livelihood for his son-in-law, first took the young man into the firm as a learner or apprentice. Finding, perhaps to his surprise, that the youngster possessed ability undreamed of until put to the test, the older man shared the authority over and the responsibility for the management of the business with the younger man. Thus was the general partnership born.

The general partnership differs from the individual proprietorship by admitting to its ownership and control two or more persons. It is a common-law type of business enterprise, based upon a contract: written, oral, or even implied. It is expected that ownership, control, and profits will be shared according to the proportions agreed upon in the contract. It enjoys most of the advantages possessed by a sole proprietorship and suffers from its disabilities. Like its predecessor, those who participate as general partners assume unlimited liability for its obligations. In addition, since two or more people are concerned with its decisions, it runs the risk of lack of unity of purpose which may even result in its dissolution. Offsetting this, in part at least, the partnership is supposed to gain both in capital and in ability from the presence of two or more owners and managers.

In addition to the general partners who assume full responsibility and presumably enjoy commensurate authority, the general partnership may contain a variety of kinds of partners whose relationship to the enterprise may assume various modifications in comparison with the general partners. For our purposes, it is not necessary to include these modifications at this point.<sup>1</sup>

<sup>1</sup> See Donaldson, E. F., "Business Organization and Procedure" (New York, 1938), p. 39.



One of the disadvantages under which the general partnership operates is the fact that, until recently, the law has never recognized it as a separate entity. It is always thought of as an aggregate of individual partners who are to be dealt with as individuals. Property is held in the names of the individuals. Suits are brought not by or against the partnership, but by or against the individual partners. Indeed, even though the assets of the business are more than ample to meet all its obligations, any creditor may ignore the business and bring action against any individual partner to obtain satisfaction for his claims. There is some evidence that this disregard for the general partnership as a separate entity may change to a recognition of its actual status by the courts. The evidence to support this contention is admittedly not entirely conclusive.

**Limited Partnership.**—The presence of unlimited liability for the acts of general partners causes some capitalists to hesitate to participate in this form of business enterprise. To meet the demands for release from this liability, some states have passed statutes specifically providing means of release for some members of the firm. These statutes provide for the formation of limited partnerships which must contain, however, one or more general partners with all the responsibilities possessed by similar individuals in a general partnership. Since the limited partnership is created by law, all the necessary legal formalities must be observed in establishing it. Failure to follow prescribed procedures may create instead a general partnership, with unlimited liability for all partners.

Limited partners are generally supposed to be contributors of capital only and are not intended to participate in the management of the business. By this means it should be possible for a limited partnership to have access to greater capital than if it were organized merely as a general partnership. Its chief added disadvantages are associated with its statutory character. Failure to observe all legal formalities or attempts to operate in areas not covered by the jurisdiction of the state that gave it birth may result in complications.

There was a time when it was thought that the limited partnership would become an active competitor of the corporation. Originating in France in the seventeenth century and used first in this country in Louisiana, it was later adopted in other states. In 1822, New York passed a law permitting the use of limited partnerships with one or more general partners who must be jointly and severally liable for the debts of the firm. In addition, one or more special partners who contributed capital could even participate in the management, provided that they were not known to the public as partners. These special partners were to enjoy limited liability by not being held for the debts of the firm beyond their capital contributions. Even these inducements failed to cause a rush to

use the limited partnership instead of the more popular form of business organization known as the "corporation."

Here, then, we have taken the second step in our progress from the individual proprietorship toward the corporate form of business enterprise. The general partnership provided the participation in ownership and control by more than one person. The limited partnership, under legal sanction, introduces the important concept of limited liability.

**Partnership Association.**—In a few states—Michigan, New Jersey, Ohio, and Pennsylvania—permission has been granted by statute for the organization of limited partnership associations, all of whose members enjoy limited liability for the financial obligations of the enterprise. Like both the general and the limited partnerships, however, the partnership association members can be given a voice in the management of the firm only by election. While shares may be freely transferred, a voice in management is granted to the transferee only by election by the existing shareholders. In case such voice is denied, the holder of the shares may demand that the association purchase his shares. If necessary, in the absence of a negotiated price, a court may be asked to determine the fair value of such shares. This failure to give the transferee of shares automatic voice in management denies one of the major features of the corporation, to be discussed later. Other features of the partnership association similar to the corporation are the use of certificates of ownership and the placing of the control in the hands of an elected board of directors or managers. In some cases, the board may even select officers to execute its policies.

In spite of the advances made by the partnership association in the progress toward the corporate form of business enterprise, it is not commonly used. In only a few states does legislation permit this form of organization. Other states are under no compulsion to give recognition to partnership associations as such. Instead they may consider them to be general partnerships, thereby denying their members their supposed advantages of limited liability. In analyzing the reasons for the infrequent use of this type of business organization, this limitation is important. Also there appears to be insufficient reason why the organizers should not go the whole distance and incorporate their enterprise.

**Joint Venture.**—A special type of partnership is known as a "joint venture," or "joint adventure." As the name implies, it represents an adventure undertaken by two or more persons. Frequently this adventure is of a speculative nature, such as the purchase of a piece of real estate for the purpose of disposing of it at a profit. Only the manager of the venture is usually known to the public. He may hold the property of the enterprise in his own name or jointly with one or more other participants. The relationships among the partners are determined by contract.

Since this type of partnership is organized for the conduct of the business affairs of a single business venture, the partners are not held liable for obligations incurred by any member who is not directly related to the specific venture. Otherwise they have unlimited liability as in any other general partnership. The termination of one venture may be followed by the organization of another involving the same parties.

Joint ventures are sometimes known as "syndicates." This is not to be confused with underwriting syndicates, to be discussed elsewhere in this text.

**Mining Partnership.**—A type of business venture whose peculiar character has called forth a special kind of business organization to meet its needs is that found in mining and in drilling for oil. The highly speculative nature of mining and oil drilling attracts the roving kind of person who is not content to remain at one spot unless success quickly crowns his efforts. Working a mine or drilling an oil well represents a kind of operation that must be pursued continuously in order to ensure whatever success is possible. Hence the nature of the enterprise, coupled with the character of the people engaged in it, dictates that the form of business organization shall be very flexible. A peculiar type of partnership has been developed to meet this need. It is known as a "mining partnership," even though it may be used in exploiting an oil lease.

Unlike other partnerships, any partner may dispose of his interest without the consent of the other partners. The new owner must be accepted as a member of the firm. Furthermore, mining partners do not have the same right to enter into contracts that bind all partners, as in the case of general partnerships. One partner is usually designated as manager. His acts bind all other partners to full liability for all debts incurred in the interest of the venture. Some partners who merely contribute capital may never go near the mine or the oil well.

At the outset, mining partnerships were organized under common law, which recognized the peculiar nature of the organization needed. Later statute law has sanctioned this form of business enterprise in some of our mining and oil-producing states. Such partnerships may be formed either by specific written contracts or by accepting the status of mining partners without any formal agreement.

**Joint-stock Company.**—Still another modification of the partnership type of business organization that partakes of some of the characteristics of the corporation is the joint-stock company. It may be thought of either as a multimembered partnership or as a kind of corporation. It partakes of the nature of both. It can be formed under common law, although in some states it receives statutory recognition.

Ownership in a joint-stock company is evidenced by share certificates which are freely transferable. Thus this type of business enterprise

differs in one material respect from the general partnership whose members must be mutually satisfactory. This transferability of shares relieves the joint-stock company from the necessity of dissolving should anything happen to a member to affect his capacity to serve the organization. On the other hand, all members have unlimited liability for the firm's debts, thus differentiating it from the corporation. This disability alone militates against its common use in this country in spite of its other similarities to the corporate form.

In comparison with the ordinary general partnership, it possesses undoubted advantages in the raising of capital, in permanence, in the transferability of shares, and in the organization of its managerial functions. But the lack of the privilege of limited liability causes most people who might be interested in this form of business organization to take out corporate charters instead. Relative freedom from regulation by governmental agencies and ease of tax burdens are not sufficient inducements to run the risk of unlimited liability. Also some consideration must be given to the fact that a common-law joint-stock company cannot sue and be sued in its own name. Like its progenitor, the general partnership, the law gives it no separate legal status. Only its members are recognized by law.

As an outstanding example of the joint-stock company organized under the common law, the Adams Express Co. may be considered briefly. This was formerly an express company but has been operated as an investment trust since its express business was taken over by the Railway Express Agency, Inc. Its experience as a joint-stock company is of interest because of the manner in which its members are relieved of unlimited liability for much of its debts. As a voluntary association, its members are supposed to have unlimited liability for all its financial obligations, except such as may be waived by contract. Indeed its stock certificates contain the following warning:

The holder of each share is subject to the payment in future of such assessments as may be necessary in case of loss or other necessity, and to all obligations and liabilities of, and entitled to all the privileges of a member of the Association and resting on each share represented by this certificate as fully as if he had signed the Articles of Association.

Nevertheless its outstanding bonds specifically exempt its shareholders from personal liability for their payment.

**The Simple Trust.**—A legal device originated for the purpose of providing protection for infants and other incompetent people, known as the "simple trust," has had wide application to the field of business relations. Applied in many fields of business control, the principles involved in the simple trust have created new forms of business organization. In the

simple trust the creator or trustor turns over property to a trustee to be managed in the interest of the beneficiaries or *cestuis que trustent*. In order that a true trust relationship may exist, the creator must give the trustee control over the property without domination of his decisions by the beneficiaries. It is understood of course that there may be one or more creators, one or more trustees, and one or more beneficiaries in each simple trust. Frequently the trustee is not an individual but a trust company.

The relationship among the parties to such a trust are important, particularly when we undertake to apply its principles to more complex business situations. The term "trust" is used in many types of business organization. If it is a true trust there must be the creator, the trustee whose actions are quite independent of control by the beneficiaries, and the people in whose interest the trust is organized. Failure to observe proper relationships may cause the law to determine that, in fact, some other form of business organization is actually present, regardless of the names used.

Should the beneficiaries (even though they are the creators as well) undertake to exercise a right to elect the trustees, to remove them, or to exercise either direct or indirect control over their decisions, they may find that they are also liable for the debts of the trust. In such case the court may decide that, in effect, a general partnership exists. Of course limited liability could be assured even in such case by contractual stipulation where unlimited liability might otherwise exist. But if the beneficiaries act in such manner that they do not try to control the actions of the trustees, directly or indirectly, they are free of personal liability to creditors. This may mean that the trustees have the right to fill vacancies in their own ranks, created by whatever cause.

**Business Trust.**—Enough has been said about the simple trust to suggest the application of the principles involved to the control of ordinary business affairs. Since any competent person may become the creator of a trust, we are not surprised at the wide use of the idea of the trust in ordinary business affairs. In many instances it is evident that the trust form is resorted to in order to accomplish some purpose that otherwise might be difficult of accomplishment because of some twist of the law. In suggesting that trusts are frequently organized to evade the law, it is possible that a careful analysis would reveal that the law is a bit too restrictive and therefore perhaps it should be evaded or amended.

**The Massachusetts Trust.**—For example, in the Commonwealth of Massachusetts, the law formerly prohibited the formation of corporations for the purpose of holding and dealing in real estate. Since individuals who wished to engage in the business of owning real estate could not secure the advantages of limited liability by the process of incorporation, they

resorted to the trust as the means of evading the law. The fact that Massachusetts has since eliminated this prohibition from its corporation code suggests that the law was in error on this point. It was evidently a carry-over from an early prejudice on the subject of corporate holdings of real property. The Massachusetts trust was used as the vehicle for evading a law that worked an unnecessary hardship on real estate ownership. By following the principles described above for the simple trust, an adequate substitute for a real estate holding corporation was developed.

Having established a form of business organization that served one useful purpose, it soon became evident that the same type of control could be applied elsewhere and for other purposes. Thus was born the famous Massachusetts trust, which has enjoyed wide popularity in many sections of the country. Some proponents of its use profess to see in it a complete answer to the growing problems that vex corporate promoters and managers. To be sure, it possesses many of the attributes of the corporation. These will be reviewed briefly.

The management of a Massachusetts trust is vested in a board of trustees. Unless otherwise stated in the trust articles, the trustees act as principals and are personally liable to creditors for the debts of the trust. Needless to say, they can be relied upon to take care to avoid this liability. In any event, they are not the agents of the beneficiaries and are not responsible to them for their acts, so long as they conduct their affairs in accord with the instrument that grants them authority. If for any reason the beneficiaries should question the good faith of the trustees, they may appeal to the courts for a review of the trustees' decisions. In no event do the beneficiaries possess the power of removal and replacement of the trustees.

If the operations of the business are such that a set of officers is needed to execute the policies of the trustees, the trustees are authorized to select them. Such selection does not relieve the trustees of any responsibility for the acts of persons so selected.

Ownership of the assets controlled by the trust rests finally with the beneficiaries. Evidence of such ownership exists in the form of trust certificates which possess all the attributes of stock except the right to vote. They may be listed on stock exchanges, may be transferred readily, and their owners may receive dividends on them.

**Duration of Trust.**—Under common law a trust may not enjoy perpetual life. A few states have passed laws that grant permanent existence. In most states the life of a trust is limited to a period not longer than 21 years and 9 months after the death of some person or persons named in the declaration of trust. Frequently the term of the trust is much shorter, being a fixed number of years or being governed by the happening of some

event named in the trust instrument. The trust may be dissolved before the date so fixed. While the limitation on the life of the trust is an argument against its use, such limitation may be more academic than real. At the expiration of the life of the existing trust, the control over the property reverts to its owners. If they can then agree upon the terms of a new declaration of trust and upon a set of trustees, they can probably continue the effective life of the trust indefinitely. Although this procedure is not quite so simple as the renewal of a charter of a corporation, it is not too compelling a reason against the use of the trust form. To be sure, the credit standing of the trust might be brought into question as the life of a specific trust draws to a close. This is a subject that might be important in one situation but nonexistent in another.

**Freedom from Taxation.**—One of the arguments formerly used to urge the substitution of the Massachusetts trust for the corporation was its freedom from the taxation imposed upon the latter. It was contended that since the Massachusetts trust is not a creature of the state it is not subject to the different kinds of taxes assessed against the corporation as such. While there are still no fees corresponding to the incorporation fee of a corporation, the tendency is very definitely in the direction of imposing what corresponds to annual franchise or license taxes on trusts and corporations without discrimination. And both state and national governments tend to treat both forms of business organization alike in collecting income taxes.

**Extent of Use.**—Massachusetts trusts have enjoyed wide popularity in some states for particular purposes. In real estate holdings, both in the state of origin and elsewhere, this form of business enterprise has been used extensively. Land trust certificates, described elsewhere in this text, have frequently been issued under the trust form. But it is evident that this type of business enterprise has never caught the imagination of business leaders to the extent that there is any likelihood that it will ever displace the corporation in public favor. For the most part, the trust form has been used either to effect a temporary purpose, or in situations where for one reason or another the corporate form was prohibited.

**Summary of Advantages and Disadvantages.**—Because of the preference for the Massachusetts trust in some quarters, it is thought desirable to summarize its advantages and disadvantages. The former include the following:

1. It is easily formed.
2. Owners are not personally liable to creditors. Even trustees are usually absolved from personal liability by contract.
3. Easy transferability of shares, plus limited liability, attract capital.
4. The management is unhampered by the necessity for submitting to election by owners.

5. It is more stable than a partnership because the death of a trustee does not result in a dissolution, but only in the selection of a successor.

6. It is comparatively free from regulation by the state.

Against these alleged advantages, we must weigh several distinct disadvantages as follows:

1. Since its legal status is dependent upon court action in each case, rather than upon an adjudicated code, there is always doubt about the existence and the extent of personal liability for the debts of a trust.

2. Lack of understanding of its rights and obligations on the part of the public operates against the wide use of the trust form.

3. The relations of the beneficiaries to the trustees are not determined as a matter of law but must be fixed when the issue is drawn by the court that adjudicates the case. There is always the possibility that the court may declare a trust to be a general partnership.

4. The limited life raises some question about its permanency.

5. If the use of the Massachusetts trust should become general, it is contended that it would be taxed and regulated exactly as if it were a corporation.

**Other Types of Business Organization.**—In this brief summary no attempt has been made to exhaust the discussion of all possible forms of business organization other than the corporation. Neither has any attempt been made to answer all possible questions about the forms discussed. Rather two things have been attempted: (1) to show that, beginning with the simple individual proprietorship, there has been a gradual evolution of business enterprise as economic conditions became more complex; and (2) to point out the sources of strength and weakness of the various forms discussed as a basis for comparison with the business corporation.

As the reader has no doubt observed, each of the types of business organization thus far discussed possesses possibilities for both strength and weakness. Some are well adapted to certain kinds of business enterprises, particularly those of a local or temporary nature. Others seem ill adapted to meet the needs of modern business organization, and it is not surprising that they are not commonly used. For general purposes, none of the types discussed is so well suited to the needs of both business managers and investors as the corporation. It is for this reason that detailed attention will be given to the business corporation in the chapters that follow.

**Kinds of Corporations.**—Before taking up a discussion of the business corporation, it should be noted that throughout this text the term corporation is applied as though it meant only the one that is organized for business purposes. In addition, there are numerous other kinds of corporations which are identified here for purposes of contrast. The first



division of corporations should be between public and private. Public implies either those which are organized to conduct public business, such as municipalities and incorporated villages, or those which have as their function the performance of duties formerly imposed upon private enterprise. Owing to some emergency that creates hazards greater than private enterprise cares to bear, governmental agencies are sometimes organized to ensure continued service to the public. Numerous alphabetical agencies of the decade of the 1930's can be classified in this category, such as the Reconstruction Finance Corporation, the Home Owners Loan Corporation, and the Federal Deposit Insurance Corporation.

Private corporations may be divided into those which issue stock as evidence of investment and those nonstock corporations which substitute membership as the basis of organization. By incorporating, the latter may ensure a permanent plan for holding property and making contracts. They include corporations for such purposes as social clubs, fraternities, charitable, religious, and educational institutions, and some mutual and cooperative ventures whose object is not measured in terms of profit. Stock corporations are private in nature and are organized in the hope of profit.

There are various methods of classifying stock corporations. One divides them into three groups as follows:

1. Public-service corporations, including at present such corporations as steam railroads, gas and electric companies, street railways, telephone, telegraph, and water companies, have the peculiar characteristic of possessing special rights, granted by franchise, to use public property for private use. They are generally under special control of commissions which regulate them. The special features of such corporations which classify them as public utilities will not be discussed.

2. Moneyed corporations, such as banks and insurance companies, and investment companies in those states which have already begun to supervise their activities, are usually organized under special laws and subjected to special regulations. These special features are omitted from this text.

3. Private corporations, constituting the main thesis of this text, are those engaged in the ordinary business operations of commerce and industry. Most of these are stock corporations, whose ownership is evidenced by the issue of stock. This group is subdivided for various purposes to suit the needs of particular individuals. For example, the investment banker frequently speaks of rails, gas and electric companies, steels, mines, oils, etc.

## QUESTIONS AND SUGGESTIONS

1. Is it always advantageous to incorporate business enterprises? Explain.
2. Contrast common law with statute law, and give illustrations of each.
3. Describe the organization and operation of a sole proprietorship. In what types of business operations are they particularly useful?
4. What is the relationship of administrative commissions to the law? Give illustrations.
5. Describe the general partnership. How does it differ from the sole proprietorship?
6. How does a limited partner differ from a general partner? How does he attain the status of a limited partner?
7. Why is the limited partnership not so commonly used as the corporation?
8. Describe the partnership association, and point out its weaknesses.
9. To what types of business operation is the joint venture applicable?
10. Account for the differences between the mining partnership and other types of partnerships.
11. How does the joint-stock company differ from the general partnership? How does it differ from the corporation?
12. What is a simple trust? What is its origin?
13. Under what circumstances may a trust be considered a partnership?
14. What is the Massachusetts trust? Do you think it will supersede the corporation in common use? Why?
15. Who owns the Massachusetts trust? How is ownership evidenced? Who manages it?
16. In what kinds of business operations is the Massachusetts trust used?
17. What kinds of corporations are there other than those organized for business purposes? With what kinds are you familiar?
18. How does a public corporation differ from a private corporation? Are there any of the former in your community?
19. What particular kinds of public corporations were created during the decade of the 1930's? Mention several.
20. Name all the corporations of which you are a member.
21. Into what classes are stock corporations divided? Who makes these classifications and why?
22. From sources other than this text, find out what other classifications of corporations are used. Name two such classifications.

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**SUBJECTS FOR INVESTIGATION**

1. Summarize the law of your state on the subject of limited partnerships.
2. From the financial pages of any metropolitan newspaper select: Three railroad corporations, three industrials, three moneyed corporations, three public utilities, and three whose names tell nothing about the nature of their business.
3. What forms of business organization have been used by the Adams Express Company?

## CHAPTER III

### CORPORATE ORGANIZATION

**Prevalence of the Corporation.**—In terms of the total production and distribution of goods and services in this country, business enterprises that employ the corporate form account for more than three-fourths of all business done. Although corporations are numerically less common than other forms of business organization, their larger average size gives them the preponderant position in the total business picture. The amount of business done by corporations will vary of course with the type of business. For example, nearly all mining and quarrying is organized under the corporate form. Corporations account for more than nine-tenths of all manufacturing, perhaps three-fourths of the volume of wholesaling, probably about one-half of the retail business, and less than one-tenth of agriculture.

Banks, insurance companies, railroads, and public utilities are almost always incorporated. The only exceptions are some publicly owned utilities. The reasons why there is almost universal use of the corporate form in these fields are obvious. In those businesses in which the corporation is less commonly used at present, the tendency is unmistakably in the direction of the extension of the use of the corporate form. This is certainly true of the retail business, with the constant displacement of individually owned establishments by chain stores. Even in agriculture, the corporate form is being used to an increasing extent, both in the actual operation of farms and in the areas of business endeavors that are on the border line between farming as such and manufacturing and merchandising.

Only in the field of personal service is the corporation apparently barred. Here the relationship between counselor and client is such that it is supposed to be maintained on a man-to-man basis. To date we have not encouraged the organization of legal or medical corporations, for example. However, it is not at all certain that group-health programs, legal-aid clinics, professional collection agencies, etc., may not open the way to the eventual use of the corporate form even in personal services.

Even governmental agencies are making increasing use of the corporate device. We have recognized for some time the corporate character of municipalities. More recently, the encroachment of the Federal government, particularly upon the territory heretofore confined to private busi-

ness, has utilized the corporation as the vehicle for conducting its business affairs. The list of government-owned corporations already engaged in various kinds of business is long and growing. The start that has already been made may point the way to further participation by the government in what has commonly been considered to be private enterprise.

**Meaning of Corporation.**—Unlike the simpler forms of business organization that require no special legal sanction for their existence, the corporation is the result of a fairly definite plan. This does not imply that the plan has been immutable throughout the years. On the contrary, the rules governing the corporate form have changed materially from time to time and are still subject to further modifications. Nevertheless, there is a much more formal procedure that must be followed in the adoption of the corporate form than in the introduction of any other type of business enterprise.

This formality is succinctly recognized in the oft-quoted definition by Chief Justice Marshall in the famous Dartmouth College case. While speaking of a nonbusiness corporation, the words he used convey the common idea of the nature of a business corporation when he said:

A corporation is an artificial being, invisible, intangible, and existing only in contemplation of law. Being the mere creature of law, it possesses only those properties which the charter of its creation confers upon it, either expressly, or as incidental to its very existence. . . . Among the most important are immortality, and, if the expression be allowed, individuality; properties by which a perpetual succession of many individuals are considered as the same, and may act as a single individual. They enable a corporation to manage its own affairs, and to hold property without the perplexing intricacies, the hazardous and endless necessity, of perpetual conveyances for the purpose of transmitting it from hand to hand.

In this definition we find a clear picture of the differences between the corporation and the simpler forms of business enterprise.

**Legal Concept.**—In the first place, the definition states that the corporation is a creature of the law. One caution should be raised against this part of the definition, however. Since corporation codes are the prerogative of the various states, it follows that the code of one state might be different from that of another. As a matter of fact, these differences are very marked. Through a long line of decisions at common law and through the corporation codes of the various states, we have sufficiently standardized the rules of the game so that we know pretty well what to expect in any given state. We must not make the mistake of trying to play the game in one state according to the rules laid down in another. These differences, both in the corporation codes and in the interpretations placed upon them by the courts, make it difficult to state exactly what

the law is in relation to most questions involving the corporation without indicating the jurisdiction under consideration.

But Chief Justice Marshall makes it clear that the corporation is a creature of the state and has no legal existence except as contemplated by the state. Corporations acquire their legal recognition chiefly by the process of having their articles of incorporation approved. A corporation may acquire *de facto* status, even though its articles may be slightly defective, if the individuals concerned with its operation have attempted in good faith to incorporate and if they thereafter proceed to act as if they were incorporated. In other words, substantial compliance with the requirements of a corporation code may give such individuals the protection provided for corporations that have met all requirements without deviation. In addition, individuals who have not substantially met the incorporation requirements may be held to corporate obligations if they have represented to outsiders that they have formed and are operating a corporation. In this case they may be held to obligations rather than seek the protection of immunities.

**Legal Entity.**—In the second place, the corporation is endowed by the law with a distinct personality. In legal parlance, we say that it possesses legal entity. This creates a new being: artificial, invisible, and intangible but nevertheless capable of acting in most respects like a natural person. It is distinct from its incorporators. Apparently this endowment of an intangible and invisible being with legal personality originated from the negative analysis of its character.<sup>1</sup> Since it was not real, it must be artificial. Since it lacked substance, it must be intangible. In fact the legal-entity theory did more than create an artificial being with the attributes of a natural person. It endowed this being with powers and granted it immunities not enjoyed by mere natural persons.

As a legal person, the corporation enjoys at least the usual business rights possessed by other business units, subject only to such limitations as may be stated in its articles of incorporation or implied therefrom. It can sue and be sued. It can make contracts. It can acquire, hold, and dispose of property. By acting in its own right, the corporation offers unusual opportunities to the investors of funds who prefer to be relieved of the responsibility for the management of their own affairs.

In discussing the concept of legal entity, there is a tendency to over-emphasize the rights that this idea conveys without calling attention to the corresponding obligations which are presumably assumed. Undoubtedly the purpose of adopting such a conception and of applying it to business was to facilitate business operations rather than to provide a haven of refuge for those who would use the corporation to hide their

<sup>1</sup> See Rodin, Max, The Endless Problems of Corporate Personality, *Columbia Law Review*, April, 1932, pp. 643-667.

nefarious acts. In other words, the use of the legal-entity concept might easily lead to its abuse. Courts have already pointed out that the concept of legal entity may not be used to "defeat public convenience, justify wrong, protect fraud, or defend crime."<sup>1</sup> Legislatures are giving attention to bills that tend to make those who direct the affairs of corporations jointly liable as individuals for the decisions the corporation is charged with. Such action calls for nice discrimination. Undoubtedly, the corporation should be viewed as a vehicle of public convenience rather than simply as a mechanism of private gain. On the other hand, if too great emphasis is placed upon the personal responsibility of officers and directors, no one will care to take the risks of such assignments.

**Representative Government.**—One of the reasons why the corporate form should be favored in a democracy is that it is supposed to be organized and operated along the lines of a representative government. In many of the simpler types of business organization, failure of the contracting parties to agree upon a business policy may result in great embarrassment and even in the dissolution of the enterprise. Furthermore, in a general partnership, for example, any partner may bind the others by his own acts. In the corporation, on the other hand, the owners have no agency powers. They merely elect representatives to the governing body called the "board of directors." Any number of owners may be represented by the comparatively small group who constitute the board. In turn, these elected representatives do not act as individuals, but only as a group.

Again this kind of an arrangement raises some serious questions. In case the elected representatives choose to take advantage of their position and to run the corporation in their own interests, they are fairly free to do so as long as no one calls them to account. Although the law does not sanction such a procedure, it is not automatic in operation and has no police force whose function it is to seek out such violations of trust.

**Permanence of Life.**—To all intents and purposes, most business corporations enjoy the legal form of permanent existence. Actually their life may be very short. If they fail to meet the requirements of those who sponsor them or of their successors, the machinery for dissolving them is at hand. In form, many of the early charters were perpetual. This, plus the liberal-purpose clauses, has made such charters much sought after. More recently, the tendency has been to make the life of corporations subject to occasional review by the incorporating authorities. Even this does not contemplate the actual dissolution of the corporation at any specified time by mandate of public authority, so long as it continues to serve a useful purpose. It is easy to have charters renewed at their

<sup>1</sup> Sanborn, J., in *U.S. vs. Milwaukee Refrigerator Transit Co.*, 142 Fed. 247, p. 225.

expiration, provided that there are no complicating arrangements not present when the original charter was granted.

This permanent existence of the corporation affords numerous advantages. The death or disability of anyone connected with it need not influence its life. If a stockholder dies, his interest passes on to his successors. In fact, all the stockholders might dispose of their interests at the same instant of time by transferring their stock to others. Such transfer would in no way be reflected upon the immediate existence of the corporation. It might result later in a change in its policies but without necessarily affecting the length of its life. If a director dies or resigns, he is replaced. Also the corporation is much more free than other types of business organization to plan its future. It may make contracts that are practically perpetual in form, such as perpetual leases; even its borrowed money may be had for long periods of time and may be evidenced by bonds which are commonly 50 to 100 years to maturity and may even be perpetual.

**Transferability of Shares.**—One of the appealing characteristics of the corporation that attracts so many shareholders is the ease with which one may attach himself to or detach himself from the enterprise. Since most corporate shares are transferable at the direction of the old owner and the request of the new, all a prospective owner needs to do is to find someone willing to dispose of his interest. Likewise, all a discontented owner needs is to find a prospective purchaser of his stock. Stock exchanges frequently facilitate the plans of both buyers and sellers. Some owners of stock never take the trouble to record their ownership on the books of the corporation. They receive stock certificates endorsed in blank and at their convenience pass on the same certificate without having their names appear in either transaction, so far as the corporation is concerned.

It must be recognized that in some cases this ease of transferability is more apparent than real. This applies particularly to those corporations whose shares are not listed on any organized stock exchange. Lacking the open market that a stock exchange is supposed to afford to stocks listed upon it, the owner of unlisted stocks may have to "peddle" them among his friends and acquaintances until he finds some one interested in buying them. Since the initiative comes from the seller he may not be able to dispose of his stocks to advantage. The buyer probably will set the price that he is willing to pay. Even with listed stocks some are so inactive that they do not enjoy an open market. Price changes between successive sales may be much greater than in the case of stocks actively traded in. Nevertheless there is a market at a price that the seller may be glad to accept. As a consequence transferability of listed stocks is always easier than for unlisted.



Like so many other facets of the corporation, the ease of transferability of shares reflects different images in different directions. From the standpoint of the owner of the stock, he acquires a degree of liquidity and a freedom of action that is present in no other type of investment, except perhaps in some bonds. He may easily enter or leave the corporation at will. Meantime the knowledge that he can dispose of his interest merely by finding a buyer willing and able to buy on satisfactory terms tends to make him careless and indifferent about watching out for his own interests. Corporate directors in turn can rely upon this indifference to protect them against the wrath of stockholders, who might otherwise object to the mismanagement of their affairs. At least there appears to be less intelligent participation in corporate affairs by stockholders than there is in partnerships by partners. In the latter instance, the partner may not substitute transferability for intelligent interest in his own affairs.

**Limited Liability.**—Perhaps the most outstanding characteristic of the corporation which has resulted in its common use is the presence of limited liability. In nearly all other forms of business organization, there is an initial presumption that those who furnish the capital are fully liable, not only for the amount of their commitment, but also for such additional amounts as may become necessary to meet the obligations of the creditors. In most instances, the enthusiasm that furnishes the incentive to start the enterprise pushes the possibility of liability so far into the background that it is overlooked. It may come to the fore at most inconvenient times. To be sure, even in partnerships, for example, the liability of the partners on a particular contract may be limited by agreement with the other party to the contract. Two situations militate against such limiting clauses. In the first place, it might be difficult to secure the consent of the contracting party to such waiver of liability. In the second place, the enthusiasm of the partners at the time the contract is made will probably blind them to the need for such protection. At any rate, unlimited liability attaches to individual partners for the full amount of most partnership contracts.

On the other hand, the stockholders of most modern business corporations have the advantage of limited liability without doing anything about it. As stockholders, they are automatically relieved of any liability except possibly for the loss of their commitment. This means that if they have paid in to the corporation the full amount of the par value, or stated value in case of no-par stock, they might lose all that they have invested; but they could not be assessed additional amounts, regardless of the loss that creditors might be called upon to suffer. In case less than par, or stated value, has been paid in, the stockholder may be assessed up to the amount he has agreed to pay in, if added amounts are needed to meet the proved claims of creditors.

The concept of limited liability applies not only to stock purchased directly from the corporation, but to all stock that is acquired in the open market. If stock has once been issued as full-paid and non-assessable by the corporation, its subsequent sale to others will not affect this liability. For example, if full-paid stock with a par of \$100 should be bought in the market for \$10 per share, the new purchaser might lose his purchase price but could not be assessed for any additional amount, regardless of the loss that creditors might be asked to bear. It is this automatic character of limited liability for corporate stock that gives it such a wide appeal. Many purchasers of securities are willing to take a chance if they can know in advance the limit of their possible losses. In the purchase of most corporate stock, their limited liability supplies them with this information. Because this is so, it is much easier for corporations to secure capital than it is for any other type of business enterprise.

**Corporation as Financial Institution.**—What has been said so far in this chapter is an attempt to state in nontechnical terms the legal relationships established by a corporation. After all, while this is important, it is incidental to the main reasons for the prevalence of the corporate form of conducting business operations. Another way to view the corporation is through the glasses of those responsible for financing business enterprise. Because of the legal attributes that have just been described, the corporation provides a most convenient means of attracting business capital. In fact it may be said that without the use of some such device the extent of business organization which now characterizes our modern civilization would be unthinkable. How could our great railroads, our financial institutions, our industries, and our commercial giants have been financed except through the use of the corporate form?

Even though you might prefer the simple life in which modern business institutions were unknown, the fact remains that our modern civilization is dominated by business giants, made possible by the wide acceptance of the corporation as a desirable means of financing them. The record of multitudinous business failures, which have completely wiped out or at least materially reduced previous investments in corporate securities, has not prevented a constant stream of new corporations. New and, perhaps even in part, the same investors have responded to the lure of promised high returns and speculative profits by entrusting additional amounts of capital to new corporations. Indeed there are times when a major problem is not the finding of financial assistance for needy corporations, but the finding of needy corporations to absorb the proffered resources of greedy capitalists.

But let us not confuse the corporate form with big business. While it is true that big business has been facilitated by the use of the corporation, the same type of financing is available to and is commonly used by small business institutions as well. In fact, one of the reasons why many small

businesses are started is that their promoters may try out their ideas without running too great risks. If they incorporate their enterprise and it fails to measure up to their expectations, all they need to do is to abandon it and leave its carcass to be picked by its creditors.

Some corporations are organized primarily because their promoters see an opportunity to make a financial profit from the sale of stock. Measured in terms of their chances for operating success, they may fall far short of expectations. Unfortunately, we are inclined to neglect this yardstick until its use will serve no purpose other than to remind us of our cupidity. Or, put to the test of their capacity to serve desirable human needs in supplying goods or services, they may rate very low indeed. Again we have no adequate proving ground to try out new ideas. As a consequence, it is hard to distinguish between corporations which are organized for the primary purpose of lining the pockets of their promoters and those which fail merely because the ideas that were offered for exploitation were immature or erroneous. Nevertheless, there still remains one of the greatest problems of modern corporation finance—the effort to secure a financing profit as distinguished from an operating profit. Most of the critics of the latter are really thinking about the former.

**Corporation as Producer.**—The financing of a corporation assumes its need as a producer and distributor of goods and services. Furthermore, in order to justify the favors that are extended to corporations by the state, it must be assumed that businesses which employ this type of organization will render better service than those not so favored. This suggests that the financing of business enterprise is only one of its essential relationships. In addition, its dealings with those other groups in our total society which sanction its use must justify the favors it receives. The quality and the prices of its products are matters of public concern. The manner of treating its employees bears a relationship to its right to continued existence.

On the other hand, if our assumptions that corporations are efficient producers are true, then the attitude of other groups toward them should be one of sympathetic encouragement instead of nagging harassment. We should not expect to rely upon the corporation to be employer, producer, tax collector, and general “lifter-upper” of our standards of living without allowing it enough freedom to accomplish the purposes for which it was organized. It is not sufficient to insist that the managers of corporations shall look to their creators and always undertake to do their bidding. In their turn, the creators should remember why they encouraged the organization of corporations and act accordingly.

**Procedure of Incorporation.**—Formerly, corporations received charters from the legislative bodies that created them. In those days the process of incorporation was considered a privilege which the lawmaking body could grant or withhold at will. There is little wonder that, since charters were

considered to be valuable, there were plenty of people willing to pay the price to receive them. The price usually consisted of seeing the "right" members of legislative bodies and securing their approval by whatever means the circumstances dictated. Since this was a common method of securing charters, there is little wonder that many of these early charters were long on rights and short on obligations of the corporations so created.

Since each corporation so approved received a specific birth certificate in the form of a special legislative act, it was proper to speak of a corporate charter. The law sanctioning the organization of each particular corporation was drawn in the form of a charter. Eventually, the scandals that surrounded the granting of these early charters produced a public reaction against this method of creating corporations. Most states now prohibit the granting of special charters. In place of the privilege, which could be granted or withheld at the discretion of the legislative bodies, there was substituted the principle that the incorporation of a business was a right that every citizen competent to make contracts possessed. As soon as this concept of corporate creation was adopted, an entirely new procedure was called for.

General corporation codes succeeded special charter acts. These codes standardized the rules of the game and established the procedure to be followed in implementing the right to organize a corporation. Government agents were designated whose function it is to review applications for corporate charters. Literally, the process of granting "charters" ended with the abandonment of special legislation, although the term is still commonly used. Now the applicants prepare their articles of incorporation and submit them for approval. The government official to whom they are submitted acts only in a ministerial capacity. Upon review of the proposed articles, his function is to check them against the constitution and the corporation code of his state. If the proposed articles are consistent with the basic laws and if all other details are properly presented, he has no discretion except to approve the articles upon the receipt of the proper fees. If the newly born corporation wishes to display its birth certificate, it can now have a certified copy of its articles of incorporation framed and hung in its office.

**Nature of Charter.**—The charter of a corporation is more than a birth certificate. Actually, it should include with the articles of incorporation pertinent sections of the state constitution, the corporation code, and relevant court decisions. At any rate, where there is a conflict between the articles of incorporation and these basic laws, the latter govern. The charter establishes relationships between the corporation and the state on the one hand, and among the constituent parts of the corporation on the other. Once these relationships are so established, they become matters of contract which bind all parties concerned. The corporation may not

amend its charter without the consent of the stockholders and the state. Likewise, the state may not violate its part of the contract by passing legislation that would result in material changes in a corporate charter, unless it reserved the right to do so at the time it approved the articles of incorporation.

**Selecting a State.**—In planning the organization of a corporation, careful consideration should be given to the selection of the state in which to incorporate. Since charters are granted by states rather than by the national government, we find great differences among the various states in their attitude toward corporations. Some states look primarily at the functions to be performed by the corporations and undertake to frame their incorporation procedures in line with such functions. A few states still look with suspicion upon certain corporate practices and frame their restrictions accordingly. Still other states look primarily to the revenue to be obtained from the “business” of incorporating business institutions and compete with other fee-hunting states for the favor of corporate promoters.

At the outset, it would appear that the state of incorporation should be the one in which the major part of the business is to be conducted. If the business is of the nature of a bank or a public utility, it may be necessary to obtain a charter from the state in which the corporation expects to operate. Other businesses are permitted a wide choice in the selection of the incorporating state. In fact, to a considerable degree, some states tend to favor corporations organized in other states as against those having domestic charters. Incidentally, a domestic corporation is one chartered by the state in which it operates; a foreign corporation is one chartered by another state; and an alien corporation is one chartered by a foreign country. Although a state might refuse to approve proposed articles of incorporation because they do not conform to its corporation code or its constitution, it may permit a corporation organized in another state with the same articles to conduct business within its borders. Where a corporation operates in more than one state, it must choose the state of its domicile. The choice, however, may fall upon a state in which it does little or no business.

**Taxes.**—In selecting the state for incorporation, many questions are considered. Among the most important are taxes and fees. All states charge an initial incorporation fee for the granting of a charter. This is ordinarily not very large and, for the states that grant most charters, does not vary so much as some of the other taxes. In any event, it is paid only once and therefore does not loom large in the corporation's calculations. The annual franchise tax is more significant. A few states make no such annual charge. Others graduate their charges according to the amount of capitalization. Not only from past experiences but from probable

future policies, the state income taxes merit more careful study than they ordinarily receive. The growing popularity of this method of raising revenue, together with the constantly increasing demands for more revenue, will cause corporations to give particular attention to this subject in the future. Since it is fairly easy for an existing corporation to reincorporate and thereby move its domicile to another state, we may expect such shifts when the tax burden becomes too heavy. Recognition of this shiftability, on the other hand, may temper the changes in tax programs. Other taxes that affect corporations include not only those already in existence, but those which may be imposed in the search for funds to meet the ever-growing demands of government finance.

**Freedom of Operations.**—The other general subject that prospective incorporators study in selecting the state in which to incorporate concerns the general attitude of restrictive regulations. Formerly, the limitations on stockholders' liability was of considerable importance. Now that the lifting of any liability, other than that attached to the original investment, has become common, there is less reason for discrimination on this point. Other subjects that still attract attention include the qualifications required of incorporators and directors, the place of corporate meetings, the voting rights of stockholders, the right to use no-par stock, and the right to own stock in other companies. In all these instances, two sets of circumstances must be taken into account. In the first place, the tendency is for the liberal state to set the standard for all states. Rather than lose corporations to other states, modifications are made in existing codes that represent concessions on the above points. In the second place, where modifications are not made, it is frequently quite easy to evade the intent of at least some of the restrictions.

The one subject that does represent a matter of considerable concern to some incorporators is the restrictions upon the powers of directors. In general, directors desire as much freedom as possible, both from the veto power of stockholders and from the regulations imposed by inquisitive bureaucrats. If a choice is to be exercised in the selection of a state in which to incorporate, such freedom plays a major part. Here again, states compete with each other for the business of incorporation fees and the subsequent franchise taxes. Except for those states which make a bid for this business, a higher standard of control would be welcomed. But since this freedom of action is a major consideration in so many instances, the other states cannot ignore it in the drafting or the revision of corporation codes. In testing the old adage that the proof of the pudding is in the eating, it is only necessary to study the birth records of corporations to find the concentration in those states which offer the greatest inducements to corporate managers and boards of directors.

**Uniform Corporation Code.**—The foregoing discussion of the differences among states in their appeal to those whose decisions determine the state of incorporation raises the question of a uniform corporation code, applicable to all states. For more than a generation, the desirability of such uniformity has been widely discussed. There is no doubt that the differences at the outset were desirable. They afforded an opportunity to test a wide variety of practices to find those which best suited the purpose. Such experience has been before us for years. Out of these variations it has been possible to formulate a recommended code that embodies the best features of all. As early as 1928, the National Conference of Commissioners on Uniform State Laws drew up and recommended to the various state legislatures a uniform business corporation code. This proposed code purposely omitted certain questions that were most controversial, including the important subject of taxes and fees.

While this proposal has been before legislatures for nearly 20 years and while it has been considered as changes in existing laws have been enacted in the meantime, its chances of general adoption appear to be very slim. The reasons are quite evident to all who study the question. In the first place, those states which look to corporation fees and taxes as a major source of revenue are loath to give up the funds that pour into their coffers from this source. If they were to submit to a uniform code, they would lose much of their incorporation business because there would remain no significant reason why corporations should not incorporate in the state where most of their business is conducted. In the second place, it is well recognized that legislation of this character is never enacted in response to a spontaneous demand of those who cast the greatest number of votes. Even if stockholders should organize and act intelligently in their own interests, major changes in corporation codes would probably not be speedily enacted. The pressure groups that are organized and that do present their demands to the legislative bodies are those who stand to lose most by the adoption of a more strict uniform code. Under these circumstances, the uniform enactment of even a reasonably decent corporation code by all the states seems hopeless.

**Federal Incorporation.**—If uniformity of state legislation is hopeless, the only other way of securing the same kind of corporation birth certificates in all sections of the country is through the adoption of Federal incorporation. Formerly, much capital was made of the distinction between intrastate and interstate business when this subject was brought up. Whatever its merits earlier, the distinction is certainly disappearing very rapidly for most business operations. In the light of recent decisions of the United States Supreme Court, the scope of strictly intrastate business has been narrowed appreciably. Even allowing that businesses

which are strictly intrastate should not be subject to Federal incorporation, the field for Federal control is still predominant.

When our national constitution was written, the number and importance of business corporations were not impressive. Such as were in existence had more or less of a local flavor. There appeared to be no good reason why this subject should be submitted for national consideration. It is not surprising that a constitutional convention dominated by states-rights individuals should have reserved the right of incorporation, at least by implication, to the states. Meantime the character of our economy has changed materially since the constitution was first adopted. So far as business operations are concerned, state boundaries have been eliminated. Since business has largely become interstate in character, it appears that there is less reason than formerly to insist that each state should retain exclusive rights to granting corporate charters to all who prefer the kind of corporate code offered for sale.

The adoption of Federal incorporation for such businesses as are engaged in interstate commerce would solve several problems. Let us grant also that it might create new ones. From past experiences in similar situations, we have a right to assume that a Federal code would be on a higher plane than some of the state codes are at present. It would give more consideration to the rights of all who are concerned with the operation of business corporations. It is inconceivable that it would not give better protection to stockholders and bondholders than is given by the codes of those states which appeal primarily to the selfish interests of managers and directors.

A Federal code would, if made compulsory, stop the practice of shopping for charters among the states that bid against each other for corporation business. It would make unnecessary the lowering of standards for corporations doing a strictly intrastate business. It appears that Federal incorporation, to become effective, must be compulsory. Otherwise only such corporations as saw an advantage for themselves in its use would change the source of their charter. If Federal incorporation on a voluntary basis should adopt low standards in order to attract business from the states, it would fail to accomplish enough to justify the experiment.

**Federal License.**—Powerful forces oppose the adoption of Federal incorporation laws. Even the constitutionality of such legislation is questioned. As a first step, it would at least be possible to require a Federal license for all corporations doing an interstate business. No question about the constitutionality of such legislation should prevent its enactment. As a condition for securing such a license, reasonable standards of business operation could be imposed. By this means, lax state corporation codes could be supplemented. One difficulty with the proposals made in this direction to date has been that the kind of control to be exercised by the Federal government has dealt with too many subjects only remotely con-



nected with incorporation standards. Such proposals have impressed many people that the proposed license procedure would have transferred the management of business enterprise from private corporations to a bureaucratic regime in Washington.

There is a desirable middle ground between extreme bureaucratic control on the one hand, and untrammelled freedom of operations on the other. Existing corporate weaknesses discussed in many sections of this text demand correction by some realistic force. If, as seems probable, we cannot expect investors to protect their own interests; if corporate managers do not adopt a program of enlightened selfishness; if the competition among charter-mongering states results in further lowering instead of raising of standards: then only the Federal government can be relied upon to make the necessary corrections. Recent experiences with the growth of political power of groups not dominated by corporate officials suggest that such Federal regulations may some day give sweeping control to bureaucratic agencies.

### QUESTIONS AND SUGGESTIONS

1. List several kinds of business that employ the corporate form predominantly. Several kinds that make little use of this form.
2. Why are corporations not commonly used in agriculture? In the professions?
3. Make a list of government-owned corporations, and state the major function of each.
4. What are the important points made by Chief Justice Marshall in describing the corporation?
5. Explain: "The corporation is a creature of the law." What is a *de facto* corporation?
6. What is the significance of the legal entity of the corporation? What obligations are attached to the idea?
7. What difficulties may be encountered in placing too much personal responsibility upon corporate officers and directors?
8. "Owners of corporations possess no agency powers." What does this mean? Apply it to a specific case.
9. Why is it that some corporate charters granted a long while ago are quite valuable today?
10. If a stockholder dies, how is the corporation affected? If a director dies, what happens?
11. Could you be a stockholder without any corporate official or employee knowing about it? Explain.
12. What are the weaknesses of easy transferability of shares?
13. Explain fully what is meant by limited liability.
14. Why is the corporate form favored by big business? By small?
15. Distinguish between a financing profit and an operating profit. Give examples of each.
16. If you wish to organize a corporation today, what procedure would you follow? How does this differ from the procedure used a century ago?
17. Do modern corporations receive charters? Explain. What is the purpose of a charter?

18. In selecting a state in which to incorporate, what considerations should govern?
19. What forces are opposed to the adoption of a uniform corporation code? What do you think should be done about this subject?
20. Do you favor Federal incorporation of business enterprises? Why?
21. What is the difference between Federal incorporation and a Federal licensing procedure? Which do you prefer, and why?

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### SUBJECTS FOR INVESTIGATION

1. Select 10 corporations with whose names you are familiar, and find for each the date and the state of incorporation.
2. Compare the state of incorporation with the state in which the business of the corporation is chiefly conducted.
3. Which of these corporations have their stocks listed on the New York Stock Exchange?

## CHAPTER IV

### HISTORY OF THE CORPORATION

**Approach.**—In presenting a brief history of the business corporation, no attempt is made to trace its origins to their ultimate source. Probably this is not possible except by conjecture. It is to be expected that one generation learns something from its predecessors. No one would contend that the corporation is the brain child of some legal or business genius who produced it, full-fledged, out of thin air. Rather it is recognized as a result of a complex of circumstances which inherited ideas from early political, military, trade, and even religious experiences of organized groups. For our purposes, it is sufficient for us to give brief attention to the early history of business corporations as such: and then only as they have developed in this country, with brief reference to the mother country from which our own forms of business organization originated. Our major purpose in giving any attention to the past is in the hope that thereby we can better understand the present and more accurately forecast the future.

**English Origins.**—The early English guilds exhibited many of the characteristics of the corporation: perpetual succession, use of common seal, management by committee or board, use of by-laws, and, in some cases, monopolistic privileges. Need for more capital than could be supplied by the simple business organizations of the time led to the formation of the first English joint-stock company of importance—the Russian Co.—in 1553. Possibly through the influence of early religious guilds, the number of shares of these early companies was almost invariably a multiple of 12. Shareholders held general meetings and adopted rules for the government of directors. Dividends were often paid out of capital. In fact, no distinction was made between capital and profit.

The first charters were granted to trading companies. Shares of such companies usually had a fixed value. The capital consisted of the investment of the several merchants associated in the company. As early as 1615, the public was invited to subscribe to shares, sometimes by auction. By royal grant the East India Co. acquired limited liability in 1630; there was no law on the subject until 1662. Other characteristics of the corporation appeared in the years that followed. A prospectus was circulated by a Scottish cloth-manufacturing company in 1681. The East India Co. declared a 100 per cent stock dividend in 1682. Stock quotations were pub-

lished in a newspaper in 1692.<sup>1</sup> In 1702, the East India Co. had two classes of shares, one of which was, in effect, preferred.

Unincorporated companies followed in quick succession and adopted practices that brought all joint-stock companies into disrepute. The resulting disfavor culminated in the Bubble Act of 1719, which prevented groups of persons from acting as a corporation without legislative sanction. This act was not repealed until 1825. For more than a century, it effectively placed a limitation upon the use of the corporate form. Gradually the necessities of financing canals, banks, insurance, mining, and other enterprises requiring relatively large amounts of capital brought relief to the pressure against the corporate form of organization.<sup>2</sup>

The unincorporated companies had developed two weaknesses that Parliament sought to eradicate: (1) the formation of companies to take over properties at values out of all proportion to their real worth; and (2) the withholding of large blocks of shares for the benefit of insiders. What a familiar sound these objections have! The first efforts of Parliament to direct corporate practices were, therefore, written for the protection of investors.<sup>3</sup> After the repeal of the Bubble Act in 1825, Parliament began grudgingly to grant to companies the incidents of corporate organization. Again corporate privileges were granted to special enterprises, such as banks and railways, before they were made available to business generally. Meantime, in the absence of parliamentary sanction and indeed in the face of questionable legality, joint-stock companies and unincorporated enterprises made rapid advances on all fronts. Limited liability did not become a general right until 1855.<sup>4</sup>

**Early History—American.**—Penn's Free Society of Traders in Pennsylvania (1682) and a water company of Boston (1652), at least a quasi-corporate institution, are the only known American corporations in the seventeenth century. In the latter part of the eighteenth century a considerable number of special charters were granted, particularly to banks and transportation companies. The first canal company, known as the Proprietors of the Susquehanna Canal, was chartered in Maryland in 1783. In 1799, Massachusetts passed a general incorporation act for aqueduct corporations. By 1800, there had been chartered in America the following kinds of corporations: financial, 67; highway, 219; local public service, 36; business (other), 13, including 8 manufacturing companies, a dredging com-

<sup>1</sup> Walker, C. E., *The History of the Joint Stock Co.*, *Accounting Review*, June, 1931 pp. 97-105.

<sup>2</sup> Evans, G. H., Jr., "British Corporation Finance, 1775-1850" (Baltimore, 1936), pp. 1, 11.

<sup>3</sup> Hunt, B. C., *The Joint-stock Company in England, 1800-1825*, *Journal of Political Economy*, February, 1935, pp. 1-33.

<sup>4</sup> Hunt, B. C., *The Joint-stock Company in England, 1830-1844*, *Journal of Political Economy*, June, 1935, pp. 331-364.

pany, a land company, a wharf company, an agricultural company, and a company for procuring an accurate map of New Jersey.

Predecessors of the business corporations in the field of manufacturing were of two sorts: (1) unincorporated joint-stock companies, formed in considerable numbers after the Revolutionary War, to whose capital not only individuals but towns and even states contributed; and (2) community organizations which did not ordinarily undertake manufacturing operations directly but encouraged other groups to do so, such as the Pennsylvania Society for the Encouragement of Manufactures and the Useful Arts, formed in 1787. The first incorporated company in the manufacturing field was the Director Inspectors and Co. of the Connecticut silk manufacturers, chartered in 1789. The most pretentious of these early corporations was The Society for Establishing Useful Manufactures, incorporated by the New Jersey legislature in 1791. Ambitiously conceived and promoted by Alexander Hamilton to make America independent of all the world in manufactures—by the use of Dutch capital for the most part—the Society died a lingering death without justifying the hopes of its founder.

Limits upon the amount anyone could subscribe to the stock of a corporation and limits on voting power were common in these early charters. Turnpike stocks had a par as low as \$20, with \$25 common. The early banks and canals commonly fixed the par of their shares at \$250 and \$500. Par of \$1,000 was sometimes used, even by manufacturing corporations. In a considerable number of companies, no fixed par was established. In such cases, shareholders were assessed from time to time as funds were needed.<sup>1</sup>

**Early Fear of Corporations.**—In America, as in England, corporations were early identified with monopolies. In 1821, New York amended its constitution to prohibit the granting of private corporate charters except with the consent of two-thirds of the members of each branch of the legislature. In 1846, it revised its constitution again and provided that such charters could be granted only under general corporation laws.<sup>2</sup> Writing at the end of the first quarter of the nineteenth century, Kent said: "We are multiplying in this country, to an unparalleled extent, the institution of corporations, and giving them a flexibility and variety of purpose unknown to the Roman or the English law."<sup>3</sup> In 1831, Angell and Ames commented:

In no country have corporations been multiplied to so great an extent, as in our own; and the extent to which their institution has here been carried, may very properly be pronounced "astonishing." There is scarcely an individual of respect-

<sup>1</sup> Davis, J. S., "Essays in the Earlier History of American Corporations" (Cambridge, 1917), *passim*.

<sup>2</sup> Kent, James, "Commentaries on American Law" (Boston, 1896), 14th ed., Vol. II, pp. 414-415.

<sup>3</sup> Kent, *op. cit.*, p. 433.

able character in our community, who is not a member of, at least, one private company or society which is incorporated.<sup>1</sup>

To get away from its implications, "corporation" was omitted from the New York Free Banking Act of 1838 and "association" was substituted. Both state and national banking laws still use the latter term.<sup>2</sup>

**Limping Charters.**—A hesitancy to grant corporate charters produced a flood of enterprises organized without benefit of incorporation. In the early part of the nineteenth century, laws were passed incorporating companies with partially limited liability. Some made shareholders liable for the debts of the company incurred while such shares were held, exempting trustees from such liability. In some cases the corporation could dodge this liability if it chose to certify to county officials the amount of its capital stock. The liability was imposed only after a reduction in capital resulting from a distribution to shareholders. In the beginning, discrimination was practiced against those corporations whose private interests outweighed public benefits. They were given limping charters, which denied the privilege of limited liabilities.<sup>3</sup>

**First General Corporation Law.**—The first general corporation law, passed in New York in 1811, was limited to companies organized for the "purpose of manufacturing woolen, cotton or linen goods, or for the purpose of making glass, or for the purpose of making from ore box-iron, anchors, mill irons, steel, nail rods, hoop iron and iron mongery, sheet copper, sheet lead, shot, white lead and red lead." Corporations organized under this law were limited to a life of 20 years. Directors were called trustees. The total capital stock was limited to \$100,000. Nothing was said about the number of shares or the amount to be assigned to each share. Limited liability was granted in the following terms: "for all debts which shall be due and owing by the company at the time of its dissolution, the persons then composing such company shall be individually responsible to the extent of their respective shares of stock in the said company, and no further."

**Change of Attitude.**—From 1809 to 1830, shareholders in manufacturing corporations in Massachusetts were liable, under their charters, for the corporation's debts. In 1821, a general statute was passed providing that "every person who shall become a member of any manufacturing corporation which shall hereafter be established within this commonwealth, shall be liable, in his individual capacity, for all debts contracted during the time of his continuing a member of such corporation." This liability was peculiar

<sup>1</sup>Angell, J. K., and S. Ames, "A Treatise on the Law of Private Corporations Aggregate" (Boston, 1832), p. 361.

<sup>2</sup>Hammond, Bray, Free Banks vs. Corporations; The New York Free Banking Act of 1838, *Journal of Political Economy*, April, 1936, pp. 184-209.

<sup>3</sup>Livermore, S., Unlimited Liability in Early American Corporations, *Journal of Political Economy*, October, 1935, pp. 674-687.

to members of manufacturing corporations in Massachusetts, although exceptions are found in other states. In 1830, this law was superseded by one that limited liability to full payment on the stock subscribed.<sup>1</sup>

**Illinois Corporation Law, 1872.**—Under the general corporation law passed in Illinois in 1872, "shares of stock shall be not less than ten nor more than one hundred dollars each." The law states, "If the indebtedness of any stock corporation shall exceed the amount of its capital stock, the directors and officers of such corporation assenting thereto, shall be personally and individually liable for such excess to the creditors of such corporation." Concerning reports this law provides: "If any certified report or statement made, or public notice given by the officers of any corporation, shall be false in any material representation, all the officers who shall have signed the same, knowing it to be false, shall be jointly and severally liable for all damages arising therefrom."

On the question of limited liability, this law says:

Each stockholder may be required to pay his pro rata share of such debts or liabilities, to the extent of the unpaid portion of his stock, after exhausting the assets of such corporation, and if any stockholder shall not have property enough to satisfy his portion of such debts or liabilities, then the amount shall be divided equally among all the remaining solvent stockholders.

**Remnants of Liability.**—Up to 1931, the corporation laws of California provided that each stockholder was liable for such proportion of the debts of the corporation contracted in California during the time he was a stockholder as the amount of stock owned by him bore to the total subscribed stock of the corporation. Under Michigan law, stockholders of every corporation are individually liable for all labor performed for such corporation. Any shareholder who receives any dividend or distribution may be held liable for that amount. The Pennsylvania business-corporation law provides for personal liability of shareholders of business corporations on account of salaries and wages of employees in an amount equal to the value of the shares owned (par value or consideration received by the corporation in the case of no-par stock). Suit must be brought within 6 months from the date the salaries and wages became due. The corporate property is subject to first levy, with subsequent prorata contributions from solvent stockholders.

**Post Civil War Development.**—America did not begin to enjoy extensive industrial and commercial development until after the Civil War. As a consequence, except for special types of businesses that needed more capital than the usual small local store or home-based factory required, the corporation did not come into its own until the decade of the 1870's. The rapid expansion of railroads, followed by the development of factories which

<sup>1</sup> Angell and Ames, *op. cit.*, p. 361.

experimented with mass production for the first time, invited the formation of an increasing number of business corporations. It is not surprising that the last quarter of the nineteenth century, which witnessed the rapid growth of the population and the wealth of the United States, should also have experienced the arrival at maturity of the business corporation as the agency that utilized the growing population to create the growing wealth of this country.

**Financial Personalities.**—Nor is it surprising that this quarter century provided the proving ground for testing the mettle of those financial and industrial giants whose names are closely linked with American economic history and especially with corporate capitalism. The House of Morgan displaced Jay Cooke as the preeminent financier of this country. Whereas Cooke had enjoyed greater success in manipulating government securities than in the financing of corporations, Morgan first beat Cooke at his own game and then went on to leadership in the field of corporate finance that is still unequalled in our history. Other bankers who have made their name in corporate financing and who had their start in this period were Kuhn Loeb, Speyer, Brown Brothers, and J. & W. Seligman.

In the new and rapidly growing railroad industry the Drews, Fiskes, Goulds, Vanderbilts, and Hills enjoyed their heyday until the coming of Harriman, whose genius for combining finance and successful railroad operation overshadowed all predecessors. Hill was an empire builder so long as he had at his back the financial genius of Morgan. Harriman brought financial judgment to a sick industry which he soon learned to cure. And of course in the field of industrial development Carnegie and Rockefeller occupy front rank. The latter in particular profoundly influenced the course of development of American business finance for a long period of time. Through his success in dealing, to his satisfaction, with competition, consumers, transportation agencies, and the general public, he set the pattern for big business which still governs much of our thinking. Incidentally, his methods of operation had more influence than those of any other man upon the passage of legislation like the Interstate Commerce Act of 1887 and the Sherman Act of 1890.

**Bryan and Business.**—Few people are accustomed to associate William Jennings Bryan with business organization. His numerous interests in evolution, Chautauqua, religion, and a host of other issues has tended to cloud his ventures into politics, except to record only that he was thrice an unsuccessful candidate for president and that he once held the title of Secretary of State. Probably his greatest opportunity for molding the development of the economic system of America passed with his defeat for the presidency in 1896. On the records, he was the unsuccessful champion of free silver—which even his followers failed to understand. Actually, he was the apostle of the small businessman in his objections to the continued



encroachment of corporate enterprise upon his field of operations. Had Bryan been elected in 1896 and had the country continued to support the ideas that he fostered, our corporate history since that date might have been different.

Bryan's defeat, coupled with the return of prosperity soon afterward, gave the green light to big business in America. Since that time its supremacy has never been successfully challenged until its own excesses caused its capitulation to an antibusiness government after the record-breaking collapse of 1929. Meantime, Bryan's availability to lead his country was made known to the voters twice after 1896, as a candidate for president, and at various other times when others received the nod of his party leaders against the wishes of Bryan himself. But after 1896, few leading capitalists took him very seriously. He had ceased to be a menace to their continued supremacy.

**Evolution of Business Control.**—The defeat of Bryan as the champion of the small businessman occurred just when a major change in the control of American corporations was in the making. Early in American history, the merchant prince had dominated business operations at a time when manufacture lived up to the derivation of the word—making by hand. As soon as the consumer became a producer with a specialty instead of a man who produced for the consumption of himself and the members of his family, he needed a market for his surplus goods. As a manufacturer part of the time and a peddler the rest of the time, he made less satisfactory progress than he hoped for. The merchant supplied the missing link between the producer and the consumer. He marketed the goods of small producers and soon came to dominate business operations. From this dominance he earned the title of merchant prince.

With the increase in size of manufacturing operations and with the widening of the market which improved means of transportation brought to the manufacturer, the merchandising functions of the local merchant no longer met the needs of the producer of the goods. The latter regained control of his market and relegated the merchant prince to a position of being merely a merchant—a local dispenser of the wares of the manufacturer. For a considerable time thereafter the captain of industry caught the imagination of the American people and became the dominant leader in our industrial life. He employed increasing numbers of people, built larger plants, and established the tempo of a country growing rich at a rapid rate from the exploitation of our natural resources. It was in the period from the Civil War to the turn of the nineteenth century that the captain of industry held undisputed sway over our industrial life.

Although the captain of industry became fabulously rich and assisted his contemporaries in attaining higher standards of living, he always fell short of American ideals of a gentleman. Even his lavish endowments of chari-

table, educational, and religious institutions could not remove the aroma of his pig-iron furnaces and his refinery vats or drown out the clang of his railroads and the squeals of the hogs in his slaughterhouses. While his acceptance into the elite of society depended upon such ethereal notions as these, his downfall as the leader of our economic system was dictated by something much more tangible. With notable exceptions, he was never quite able to appropriate to his own uses the finesse of the market place and the magic of the counting room. He was dependent upon others for the financing of his growing operations. Among the notable exceptions that come to mind are Andrew Carnegie in the last century and Henry Ford in this. Both made marked progress in their chosen fields without the assistance of professional financiers. Indeed both were violent critics of banking practices and are reputed to have enjoyed many a tilt with banker opponents. Others who opposed financial leadership were less fortunate in the consequences.

**Emergence of Financial Control.**—The one-sidedness of the captain of industry caused him to surrender his leadership to one who knew better the ways of financial manipulation. With increasing size of industrial units, resulting in increasing dependence of industry upon access to the money markets where they could secure the contributions of large numbers of capitalists, the captain of industry was forced to go to the financier for assistance. The latter was not slow to grasp the opportunity to provide not only assistance, but leadership as well. Not satisfied with a monetary commission for the sale of industrial securities, the financier demanded also a sizable share of the controlling stock as part payment for his services. Once he was in a position to vote at the seats of the mighty, he soon learned to initiate and to vote for proposals that resulted in combinations of corporations, with the resultant need for the flotation of new securities. The disposal of the latter always entrenched the financier further in control, because each new sale meant a new bonus of voting stock to himself and his associates.

This change to financier control occurred most markedly at the turn of the century. The boom that followed the depression of the early nineties created tremendous demands for goods which could be met only by erection of new plants and the expansion of old ones. All this called for new capital. And the financier held the keys to the vaults where such capital was stored. While it was scarcely recognized at the time, the change that occurred in business leadership was permanent and has colored business policies and financial arrangements ever since. This change was something more than the transfer of voting power from one set of individuals to another. It was much more far-reaching than that.

**Change of Ownership.**—Andrew Carnegie and his small band of associates owned the steel business unit of which he was the head. Henry

Ford and his family own the vast enterprise that he organized—with the assistance of outside capital. This was the ownership pattern of many of the enterprises dominated by the captain of industry. When the financier came into power, this pattern changed materially for a great many corporations. Financing profits came from the sale of securities rather than from the production and distribution of goods and services. Financiers are commonly interested in such profits. The more stocks and bonds they sell, the more profits they secure for themselves. Furthermore, control is most easily secured and maintained when ownership is widely scattered. Hence, to continue control over a particular corporation without great investment in its securities, it was essential for the financiers to keep at least the voting stock widely scattered.

Also by issuing a variety of types of securities, only a part of which carry voting power, it was easy to concentrate control in the hands of those who own the voting stock which is personally represented at meetings. The more different types of securities offered by a given corporation, the wider its appeal to those with investable surpluses. If some prefer to buy bonds, a market is missed if only stocks are offered for sale. By offering as many kinds of securities as there are kinds of security buyers, more capital can be easily accumulated. It was easy for the financier to demonstrate his superior ability to attract the capital of these various classes of investors, in contrast to a direct offer of securities for sale by the corporation. While there is no intent to imply that this method of financing corporations changed overnight, it certainly became much more common as soon as financial control came to the fore.

Of course this change of ownership could not take place except where there was a market for the securities to be offered for sale. With the increasing number and size of corporations, the opportunities for investment of financial surpluses tends to become limited to much narrower scope than if business were conducted on a basis of small-scale units. Increasing prosperity is always accompanied by an increasing number of people with investable surpluses. With the narrowing of opportunities for starting businesses of their own, the channels for investment are reduced to purchase of government bonds, placing funds in financial institutions which act as investment agents for their clients, and the purchase of stocks and bonds of business corporations. For some years now, the supply of investment funds available for the latter purpose has been very large, especially during periods of economic prosperity.

**Profits from Adversity.**—Security purchasers who own their securities outright may feel much less affluent during periods of economic depression than when their stocks and bonds are quoted at high prices. But at least they still continue their ownership as long as they hold their securities and as long as their corporations remain solvent. Those who buy on margin, on

the other hand, may be forced to sell their securities when prices fall. If they fall low enough to jeopardize these margins, they will be sold out, regardless of their desires. This may result in a succession of owners without influencing the position of the financier, except perhaps to provide him with another opportunity for a financing profit. Also when new owners or old are induced to buy new securities which may be necessitated by economic depressions, the financier again gains.

Even when a corporation suffers such large financial losses that some kind of a reorganization becomes necessary, the financier may gain rather than lose. If he loses, his loss is likely to be in the form of the disappearance of a paper profit. Since his bonus securities cost him no money, he can lose only what he could have gained had he sold them before the price fell. Only in case he failed to do this can it be said that he suffered even a paper loss. On the other hand, when a reorganization of the corporation's finances is necessary, the financier may have the opportunity to sell the new securities that are needed to provide new money.

**Penalties for Overexpansion.**—When an economic system is dominated by producers and distributors of goods and services, their overoptimism about prospects for the future may result in overexpansion of their facilities. The more concentrated the investment of their own funds, the more cautious they are likely to be about expansion. But when the investing public furnishes most of the expansion capital, under the urge of security salesmen, the industrial and commercial leaders have less to lose by responding to the demands for expansion. The burden of expansion penalties falls upon those who supply the capital. Neither the jobs of corporate directors and officers nor the profits of security salesmen are at stake, except temporarily, when such mistakes are made.

Add to this the urge to create new securities, even when physical plant expansion does not result, and we have the explanation of many of our headaches of the past few decades of American corporate history. In the decade of the 1920's particularly, much of the new financing represented increases in stocks and bonds without corresponding increases in physical plants and equipment. That decade witnessed truly a financial dream ending with a financial nightmare.

**The Paradox of the Twenties.**—Viewed from the vantage point of hindsight, the decade of the 1920's presents a most interesting paradox in the development of American corporation finance. The close of the First World War found us with overcapacitation of plants in many industries. Railroad mileage had long since passed its peak, and recent changes in the total miles of track had been in the direction of abandonment instead of construction of new mileage. The war's demands for steel had resulted in the expansion of plant facilities. Indeed the decade opened with relatively few opportunities for the investment of new capital in American corpora-

tions. Instead, there was grave apprehension on every side about the let-down that must inevitably follow the boom years of the war.

At the same time, while wholesale prices dropped sharply at the close of the First World War, wage rates remained high, giving to labor an increase in real wages. Throughout most of the decade, investable surpluses were at record height. This meant that there was plenty of capital available for investment with insufficient demand for new plant facilities to absorb it. The results were two: (1) the creation of new securities by a process of combining and recapitalizing existing corporations; and (2) bidding for already existing securities until their prices reached fantastic heights. Much of this bidding came from a new crop of capitalists—people who never before had been purchasers of corporate securities. This decade merely recorded an intensification of changes in the concept of capitalist that had been in the making since the turn of the century.

**Older Concept of Capitalist.**—Before the advent of the modern corporation, the capitalist was the individual who owned, controlled, and managed physical property; hired labor; if necessary, took risks with his property which his own judgment dictated; and pocketed as profits the gains that his good judgment, good fortune, and the use of his property brought to him. Even when he borrowed capital to supplement that which he owned, this did not result in a separation of the three essential and related characteristics of the capitalist—ownership, control, and management.

**Corporate Concept of Capitalist.**—With the development of the modern corporation, this earlier concept of capitalist has been changed. Today the management of capital is separated from its ownership. Even its control is passing into the hands of others than the owners. The capitalist is no longer the dynamic, aggressive individual whose success in developing industry and commerce is the foundation stone of our faith in private enterprise and individual initiative. The capitalist today is the passive investor in the stocks and bonds of corporations. Active management has been transferred to a small group of corporate directors and officers.

**Changes in Economic Concepts.**—The new definition of capitalist necessitates changes in certain economic concepts of long-standing use, but of doubtful modern application. Private enterprise is being superseded by what the English please to call “public” corporations. Among the earliest observations on American corporate practices appears the following statement: “If the stock is owned by private persons, it is a private corporation, although it is erected by the government, and its objects and operations partake of a public nature.”<sup>1</sup> Capital is no longer confined to physical property devoted to the production of specific products. To most stock- and bondholders, capital is a highly liquid form of wealth, evidenced by certificates of ownership which are freely negotiable. This liquefying of individual

<sup>1</sup> Angell and Ames, *op. cit.*, p. 22.

capital ownership has become particularly marked in recent years. It has been estimated that by 1929 liquid claims to wealth had increased to 40 per cent of national wealth, or more than double the proportion present in 1912.<sup>1</sup>

Stockholders and bondholders come and go, frequently without the knowledge of the officials of the corporations whose securities they buy and sell. Profits can no longer be defined as of old. They have been split into parts and must be thought of in terms of salaries and bonuses for managerial ability, special gains for those in control who take advantage of their inside knowledge, and payments for the risks of ownership. Of the three parts to profits, ownership of capital is the residual claimant. Salaries and bonuses to management may be paid whether dividends are paid or not. It is a matter of interest that reports of corporations supplied to the Federal Trade Commission, pursuant to Senate Resolution 75, Seventy-third Congress, 1934, showed that officers of leading corporations commonly enjoyed salary increases in 1930 and 1931 in spite of decreased earnings and indeed in some cases in the face of sizable deficits. Speculative gains to insiders are unrelated to the success of the venture. If its future looks bright, they can buy stock; if dark, they can sell.

**Recent History.**—After the debauch of the roaring twenties came the period of sober reflection and of recrimination. In previous depressions, investors had lost faith in individual securities and in specific corporations. In the early 1930's, they lost confidence in our whole financial system. We shall probably never know how close we were to a complete collapse in our economic system at the time of the election in 1932. The selection of a new president caused people to wait and hope that the New Deal would solve their problems. Meantime they tried to put in the form of cash and currency even their deposits in banks. Had the "economic royalists" been interested in setting the stage for a favorable reception for the New Deal, they could hardly have done more than was done without such intent.

With a backdrop of closed banks and with an audience of millions of unemployed, the new president could forget the issues of the recent campaign and make capital for his new administration by an attack upon those whom he accused of responsibility for the stalemate into which our economic system had sunk. His explanation for the stagnation of economic processes is couched in the following excerpt from his inaugural address of Mar. 4, 1933:<sup>2</sup>

Primarily this is because the rulers of the exchange of mankind's goods have failed through their own stubbornness and their own incompetence, have admitted their failure and abdicated. Practices of the unscrupulous money changers stand indicted in the court of public opinion, rejected by the hearts and the minds of men.

<sup>1</sup> Berle, A. A., Jr., and Victoria J. Pederson, "Liquid Claims and National Wealth" (New York, 1934), pp. 77-78.

<sup>2</sup> *Commercial and Financial Chronicle*, Mar. 11, 1933, p. 1658.

13. What accounts for the emergence of financial control of American business?
14. How did the dominance of the financier affect the ownership of corporations? How did it affect their control?
15. Explain what is meant by profits from adversity. Give examples.
16. How is overexpansion of industry affected by banker control?
17. What was the older concept of capitalist? Does this still prevail in any parts of our economy? Explain.
18. How does the corporate concept of capitalist differ from the older concept? What does the corporate concept mean in relation to management?
19. What does the Englishman mean by a public corporation?
20. How has the modern corporation resulted in changes in the concept of profits?
21. To what extent do you agree with the New Deal indictment of business leadership?
22. What were the sources of strength and of weakness of the "brain trusters" of the 1930's?

### SUPPLEMENTARY READINGS

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### SUBJECTS FOR INVESTIGATION

1. From the earliest manual (Poor's, Moody's, etc.) available to you, list 10 corporations at random. Which of these are active at the present time?
2. From the latest manual available to you, select 10 well-known corporations. How many of them were in existence 50 years ago? How many were in existence 25 years ago?
3. From a study of the corporate code of your state, do you consider it rigid, lax, or moderate? Why?

## CHAPTER V

### CORPORATE CONTROL

**Process of Incorporation.**—As pointed out in an earlier chapter, the corporate charter represents the contract between the corporation and the state, on the one hand, and among the interested parties to the corporation, on the other. Since the corporation has no legal existence until it is recognized as such by the state, it must first be incorporated. Articles of incorporation, usually drawn up by a lawyer acquainted with the corporation code of the state from which the charter is to be obtained, are signed by one or more persons who are called the “incorporators.” In some instances this is about their only contact with the affairs of the business enterprise. That is why such incorporators are called “dummies.” Interested parties may lack residence requirements to become incorporators, or they may have some reason to conceal their interest, at least temporarily.

The qualifications required of incorporators are few and simple. Since the charter is a contract, the incorporators must have the capacity to make contracts. In most states, married women have been given the statutory right to make contracts, a right that was denied them by the common law. With rare exceptions, only natural persons may become incorporators. At common law, neither citizenship nor residence requirements are imposed upon incorporators. Any such qualifications must be stated in the statutes, which vary widely on both subjects. In most states it is expected that incorporators shall be subscribers for stock. In some jurisdictions this is not the case. Where “dummy” incorporators are used and where they subscribe for stock, they usually endorse their stock certificates in blank since it is intended that their relationship to the enterprise shall terminate at an early date.

As soon as all formalities are complied with and the required fees are paid, the approval of the proposed articles of incorporation by an agent of the state follows as a matter of course. The corporation is now considered to be ready to proceed on its journey toward business success or failure.

**Charter Contents.**—Although there is considerable variation among the different states on the subject of the contents of the charter, there is general agreement on the following subjects. Every corporation must have a name. In most cases it must indicate the nature of the enterprise



by including "company," "corporation," or "incorporated," or their abbreviations, as a part of the name. Although wide latitude in the selection of other words to be used in the name is permitted, certain restrictions are imposed for the protection of already existing corporations whose names have acquired value. The incorporating official, subject to court review, is the judge to determine whether proposed names might cause conflict.

In order that the corporation may be located for any legal purpose, its charter must indicate the location of its "principal" office. As a matter of experience, this principal office may serve no other purpose than to provide a place where legal service against the corporation may be lodged. All its business operations may be conducted elsewhere, perhaps even in a different state.

Since the corporation is a creature of the state, the original tendency has been to have the charter define its purposes quite specifically, particularly when special charters of early corporations granted monopolistic powers. With the adoption of general corporation codes and with the common acceptance of the corporate form of doing business, the single-purpose rule was somewhat relaxed, at least to permit activities related to the main purposes. In many cases it appears that corporations may do almost anything that natural persons may do. In addition to the powers expressly granted in the charter, corporations possess such implied powers as are incidental to the conduct of its business: such as the power to sue and be sued, to make contracts, to hold such property as is needed for its business, etc.; and such other powers as are reasonably needed to effect its purposes. There is a tendency to add at the end of the purpose clause an all-inclusive statement like "any other lawful business." In the interpretation of these clauses, the courts have pointed out that they bear a relationship to what has preceded and are limited by the main purpose clause.

If a corporation performs an unauthorized act but one that would be lawful if provided by its charter, it is said to be engaging in *ultra vires* acts. Directors and officers may be held liable to stockholders for damages resulting from *ultra vires* acts which they sanctioned. This assumes that damages result and that some interested party takes the initiative in bringing the offending parties to court. Naturally, the broader and more inclusive the purpose clause, the less likelihood of committing an *ultra vires* act.

The charter specifies the amount and kinds of stock that the corporation is "authorized" to issue. The authorized capitalization sets the maximum number of shares that may be issued unless and until the charter is amended. The latter process is not ordinarily difficult. There is a tendency for some corporations to capitalize their authorized stock by stating the amount on their letterheads and other advertising literature. It may bear but little relationship to the actual scope of its operations. In addition, the charter

must state the par value of the stock, if it has a par value. In some states, the stated value of no-par stock must be recited in the charter. When more than one class of stock is authorized, the differences among them must be carefully defined.

While the maximum amount of capitalization is stated in the charter, the laws of some states also fix the minimum amount of capital with which the corporation can begin operations. Where such minimums are stated, they are so small that little seems to be accomplished by them. In states that do not have such minimums, there is a substitute requirement in the form of a minimum amount to be paid in before operations are begun. Since all these amounts vary from only \$500 to \$2,000, one wonders what definite purpose is served by the requirement.

Special charter provisions are so numerous and so varied that a study of each corporation charter would be needed to encompass their possibilities.

**By-laws.**—At common law, corporations, like other organized groups, have the right to enact by-laws for their own internal government. Whereas statutes sometimes reaffirm this right, such provisions are quite unnecessary. Unless taken away by statute or charter provision, stockholders possess the right to enact by-laws. As a matter of practice, it is not uncommon to transfer this right to directors. In Ohio, at least, one set of by-laws, called "regulations," is formulated by the stockholders for the internal government of the corporation while another set, called by-laws, is drawn up by the directors for the control of their meetings. In general, the by-laws drawn up by the stockholders deal with such subjects as conduct of stockholders' meetings; qualifications, powers, duties, and compensation of directors; functions and powers of committees; qualifications, selection, powers and duties, and sometimes compensation of officers; stock and stock records; dividends and finances; and miscellaneous provisions, including the method of amendment. The body that has the authority to draw up by-laws almost always has the right to amend or repeal them.

**Constituent Parts of Corporation.**—Underlying the fiction of the corporate entity are men of flesh and blood whose decisions govern the actions of the corporation. At the head of the procession of individuals who constitute the corporation marches the promoter, whose functions and activities form the subject matter of a later chapter. Next come the incorporators, frequently made up of clerks in the office of the attorney who secures the "charter" for the corporation.

Upon approval of the articles of incorporation by the state, the incorporators proceed to accept their charter, adopt by-laws, and elect directors. In a few states, the election of directors and officers precedes the submission of the articles of incorporation. In any event, the functions here noted are more or less matters of form, since the first meeting of incorporators is usually a ratification meeting, merely approving minutes and resolutions

prepared in advance. After the election of directors, the incorporators may approve the exchange of stock for property, or conduct such other business as may properly come before the first meeting of stockholders.

The newly elected board of directors now takes control, elects officers, adopts stock certificates, opens the books for additional stock subscriptions, and conducts other miscellaneous business immediately at hand.

The stockholders, *i.e.*, the great body of them, are the last to join the procession. The corporation organization is completed, at least in skeleton form, and may even have begun operations before most of the stockholders join the enterprise. This is the usual procedure in corporations whose stock is widely distributed. Small corporations, whose stock is closely held, may start with all stockholders as incorporators, who then choose from their own number directors, who in turn select officers.

**Place of Stockholders.**—At the base of the corporation pyramid are the stockholders, whose control over their investment is quite indirect. Their functions are few, and they are given only infrequent opportunities to exercise them. Once a year voting stockholders are invited to a general meeting to listen to such reports as the directors and officers see fit to make, to hear discussed the general affairs of their corporation, and to elect one or more directors. Matters that fundamentally affect the life of their corporation, such as a change in the authorized capital, an amendment to the charter, or a merger with another company, are submitted at such meetings for the approval of the stockholders. On rare occasions, they are invited to assemble for a special meeting when a matter of immediate importance demands their consideration and action.

As a general rule, stockholders act only as a body, and not as individuals. In all but closed corporations, each of which has only a small number of stockholders, direct government of corporate affairs by stockholders is impracticable. They must act in a representative capacity. For this purpose, the mechanism of boards of directors has been invented. The general functions of the stockholders consist of getting the enterprise started by their votes at the first meeting of stockholders; keeping it going by the annual election of directors; and on occasion, stopping it by the sale of its assets or by the authorization of a merger or consolidation, reorganization, or dissolution.

**Stockholders' Rights.**—Nevertheless, the legal rights of common stockholders are quite numerous—much more so than their use or than most holders of corporate securities appreciate. These rights are not automatically enforced by any public or private agency. If any of them are violated, stockholders have access to the courts for relief and redress. The probabilities are that the courts are much more ready to protect these rights than are the stockholders to seek their protection. The most important of these rights are as follows:

1. To hold certificates of stock representing shares of ownership in the corporation. Generally each stockholder is given one certificate representing his number of shares acquired at any one time. If he owns 1 share or 100, he would ordinarily have only one certificate in either case. In some cases, a stock certificate is limited to 100 shares as a matter of convenience in the transfer of stock. Should he acquire more stock at a later time, he would be given another certificate to show ownership of the additional shares. Loss of a stock certificate would probably involve inconvenience but not necessarily loss of ownership of shares if the corporate record is up to date. If stock has been acquired from any individual owner and a certificate, endorsed in blank, has been given to the new owner but the stock records of the corporation have not yet recorded the transfer, then the loss of the certificate might be more serious. The important point to keep in mind is that the certificate is merely evidence of ownership and is not in itself ownership of the corporation.

2. To dispose of his stock in such manner as he sees fit. Ordinarily, to complete this transaction, it would be necessary for him to deliver to the new owner, and for the new owner to accept, the certificate of stock properly endorsed. In case only a part of the stock represented by a certificate is to be transferred, the old certificate can be surrendered to the corporation. In its place will be issued two new certificates, each for the proper number of shares to the proper owner.

3. To be notified of stockholders' meetings and to participate therein, either in person or by proxy. Usually, each stockholder may cast one vote for each share of stock recorded in his name on the books of the corporation. This right is subject to a wide variety of modifications, ranging all the way from no voting right to limited, prorata, multiple, veto, and exclusive rights. These subjects will be discussed later.

4. To share, in proportion to the amount of stock owned, in all dividends declared by the board of directors upon his class of stock. It is important to note the limitations of this right. While the stockholders are presumed to be the owners of the corporation, the prior claims of others must first be satisfied. Then the directors must decide to distribute whatever earnings are available before the stockholders may receive any dividend.

5. To subscribe for a prorata share of any increase in the amount of common stock. This right is subject to important limitations as will be shown later.

6. To receive a prorata share of any assets remaining after obligations have been met, in the event of either voluntary or involuntary dissolution of the corporation. Corporations seldom dissolve voluntarily. Even involuntary dissolutions seldom follow financial embarrassments. Instead, some form of reorganization, which may invite an added contribution from the stockholders instead of a distribution to them, may result.

7. To vote for directors. This is supposed to be one of the most important rights possessed by a stockholder. Since he cannot voice his wishes directly in trying to guide the policies of the corporation but must act through his chosen representatives, it would appear that he should take particular care in choosing directors to represent him. Actually, few stockholders in corporations whose shares are widely distributed ever attempt to make direct use of this right. In some instances, they are discouraged from trying to exercise the right to vote. Voting arrangements sometimes produce marvelous results. Kreuger and Toll stock held by insiders carried one vote per share; that held by the outside public was entitled to one vote for each 1,000 shares. The Industrial Rayon Corp. had outstanding 998,000 shares of nonvoting common stock and 2,000 shares of Class B voting stock.

8. To vote on other questions that fundamentally affect the welfare of the corporation. As stated before, stockholders seldom attend meetings. If they did, few would know how to vote on important questions other than to follow the recommendations of their leaders. There is a considerable difference in the practices of different corporations in inviting the participation of stockholders when significant questions are being decided.

Until 1932, the certificate of incorporation of the American Type Founders, Inc., included a provision that read as follows:

Directors or other officers of the corporation shall not give any mortgage or other lien in the nature of a mortgage on any assets other than real estate except by a  $\frac{1}{10}$  vote of stockholders at a meeting called for the purpose, at which meeting at least  $\frac{1}{10}$  of the full number of shares is represented.

In 1936, the stockholders of the Barber Company, Inc., ratified amendments to its certificate of incorporation to give the board of directors power to issue and dispose of bonds, debentures, or other obligations, without consulting the stockholders.

English practice on this point, as defined in the English Companies Act of 1929, is of interest. Ordinary resolutions, such as those providing for the election of directors, may be passed by a majority of eligible votes cast at a regular meeting. Extraordinary resolutions, such as those providing for voluntary liquidation of the corporation, require at least three-fourths of the votes cast at a meeting, the notice of which must recite its purpose. Special resolutions, such as those intended to amend the articles of association or change the authorized capital, require a majority of at least three-fourths of the votes cast at a meeting whose purpose has been stated in a notice sent at least 21 days in advance of the meeting.

9. To inspect corporate books and records. As the presumed owner of the corporation, this right sounds important. The common law recognizes the right of stockholders to examine corporate records at a reasonable time and place, provided that the purpose is a proper one. These limitations

raise interesting questions about the application of the right. On the one hand, it is conceivable that, in the pursuit of selfish ends, which incidentally might be adverse to the welfare of the corporation, some holders of stock might abuse this right if permitted. Or so many stockholders might try to inspect the corporate records that its normal operations might be hampered. On the other hand, refusal to permit inspection for proper purposes might be used to cover up the nefarious practices of crooked officers and directors. In the interpretation of the right, the courts have no simple task. Needless to say, however, not many stockholders ever seek an opportunity to inspect corporate books. Some corporations solve the problem by keeping complete control over the normal exercise of the right.

The certificate of incorporation of the Manhattan Dearborn Corp. of Delaware, approved in 1929, provides: "The Board of Directors . . . shall determine whether and to what extent and at what times and places and under what conditions and regulations the accounts and books of the corporation, or any of them, shall be open to the inspection of the stockholders."

10. To invoke the aid of the courts against *ultra vires* acts, mismanagement by officers and directors, and wrongful acts by majorities. Again this right is largely academic and is seldom used by disgruntled stockholders. Its exercise involves initiative, organization, and expense. Those who are attacked may normally use the resources of the corporation to finance their defense; while the plaintiffs run the risk of meeting all expenses out of their own pockets. More often than not this right is ignored even in cases where it probably should be invoked.

11. To waive any and all the above rights. This is a right that is used both actively and passively.

**Participation by Stockholders.**—In practice, those rights of stockholders most often exercised are represented by passive acceptance of dividends or the common use of the right to dispose of stock. As a rule, stockholders do not attend meetings. In a letter from the President of the Standard Oil Co. of New Jersey to the stockholders, dated June 10, 1942, the writer told enthusiastically that, "This year witnessed the largest gathering of the stockholders ever held, and in fact, one of the largest meetings in corporation history." The attendance which "overflowed the largest hall available" totaled "some 350 men and women." The total number of stockholders was approximately 145,000. Incidentally, for the second successive year the president of this company sent a "stenographic report of the questions and answers presented at the annual meeting" to the stockholders. In the covering letter the president stated, "We have nothing to withhold from our stockholders or the general public. On the contrary, we believe that complete information makes for sound public opinion. With so much at stake in the world conflict, your management regards it as particularly important now to make sure that pertinent facts about the company are available."

At the 1946 annual meeting, "some 400" stockholders, out a total of 160,618, attended.

Stockholders either sign the proxy sent them by the present officers, or drop it into the wastebasket. In most cases the effect is the same. They do not always exercise the preemptive right to subscribe for new stock issues. Seldom do they ask to inspect corporate books. And almost never do they invoke the aid of the courts to protect their interests. If a stockholder becomes dissatisfied with the conduct of his corporation's affairs, he resorts to his right to dispose of his holdings so that someone else may do the worrying.

**Directors.**—The general management of the corporation is entrusted to a board of directors, acting as a body, not singly. With all the weaknesses of this arrangement, representative government in a corporation is unavoidable. Our large corporations have tens and hundreds of thousands of stockholders. Direct control here is out of the question. Even in the smaller corporations, difficulties other than with numbers are insuperable. The main objective is to see that control by directors is really representative of the interests they represent.

Within the limits of the powers given to corporations by law and the rights of stockholders outlined above, boards of directors are supreme in their control of the destinies of their corporations. As already indicated, however, these powers are collective, not individual. When boards are large, much of the work is conducted by committees. The actions of such committees must be ratified by the boards that they serve.

Unlike stockholders, who may express their will by the use of proxies, directors may not delegate their authority to others. If any should be absent from directors' meetings, they cannot send proxies to represent them. It is possible of course for minorities to govern the corporation. In a directorship of nine members, for instance, five would usually constitute a quorum. If only five were present at a meeting, three might act. As a matter of fact, boards of directors, like all other deliberative bodies, are usually dominated by a few individuals. The others are more or less "yes men."

**Qualifications of Directors.**—In American practice, the candidate for directorship in a corporation who receives the most votes usually requires no other qualifications. No adequate standards of investment holdings or other tests are written into law or common practice. In contrast with this absence of specific qualifications, we find elsewhere examples of another sort. Each member of the board of directors of the Swiss-American Electric Co. (a Swiss corporation) must deposit with the company, for the term of his office and thereafter until released by the general assembly, 50 preferred shares, 100 shares of Class A stock, or 250 shares of Class C stock.

**Directors' Functions.**—A recent study<sup>1</sup> summarizes the functions of corporation directors as follows:

<sup>1</sup>Baker, J. C., "Directors and Their Functions" (Harvard University, Division of Research: 1945), p. 131.

In spite of the wide variations in practice, the following points are believed to outline the basic functions of an effective board of directors in discharging their responsibility for prudent management of the whole enterprise:

a. The board selects the chief executive and senior officers and makes certain that able, young executives are being developed. Also the board controls executive compensation, pension, and retirement policies.

b. The board delegates to the chief executive and his subordinate executives authority for administrative action.

c. The board discusses and approves objectives and policies of broad corporate significance, such as pricing, labor relations, expansion, and new products, as well as payment of dividends, changes in capital structure, loans, lines of credit, and public relations.

d. The board checks on the progress of the company not only as to immediate profits but also as to the discharge of its trusteeship responsibilities. Budgets, reports, inspections, and other controls aid directors in carrying out this function. They serve as the basis for the directors' most effective approach, which is to ask discerning questions from an independent outside point of view. Also, directors arrange for, control, and follow up outside audits and in general maintain vigilance for the welfare of the whole enterprise.

These functions may be performed in almost as many different ways as there are companies. This does not mean that every board is now adequately meeting its obligations and that nothing needs to be done. Specifically, the evidence shows that improvement rests upon a thorough understanding of six major factors and their interaction in each company: (1) the present and historical composition of the stockholder group, (2) the personalities in top management, directors and executives, (3) the key problems facing the business, (4) the place of the board in the informal as well as formal organization of the company, (5) the methods of communication between the board and the executives, and (6) the extent of action by the board as a group as well as the action of the directors individually.<sup>1</sup>

**Directors Who Direct.**—It is not sufficient for a board of directors to retain the services of a clever lawyer who knows how to keep them out of jail. Acceptance of membership on a board of directors is a responsibility that should not be taken lightly. It seems trite to announce such elemental truths as the following: (1) A director should have some knowledge of the business he plans to direct. (2) He should exercise honest judgment. (3) The board should supervise the officers whom they select to manage the business. (4) A director should make a full, fair, and detailed disclosure to the other members of the board of all circumstances surrounding any transactions from which he might benefit. (5) Because of the relationship between him and his stockholders, he should be very circumspect in buying or selling the corporation's stock. (6) He should make sure that financial statements are properly prepared by competent people, and he should be familiar with their content. (7) If he has any doubts, they should be resolved before he takes action that fundamentally affects the welfare of his

<sup>1</sup> *Ibid.*, pp. 137-138.



corporation.<sup>1</sup> The only justification for these observations is the too frequent presence of directors who ignore them.

**Public Relations.**—Even such an excellent summary as that included in the preceding paragraph fails to set forth the whole picture of the position the corporate director must aspire to if he fulfills his obligation to his corporation. As pointed out in the preface to this text, “the public is beginning to play a part in business operations that is apt to assume larger proportions in the future.” In the management of the corporation, the director must keep this likelihood in mind. In fact, the quality and quantity of public participation in corporate affairs will probably hinge upon the amount of attention the management gives to the interests of the consumer and the laborer as well as to those of the stockholder and the bondholder. This statement should not be interpreted to be a plea for conducting the affairs of the corporation in such a manner that those who supply its capital shall be neglected. Rather it is intended to point out that these interests will be best served if the other interests which are grouped under the somewhat misleading heading of public relations are given adequate attention in reaching decisions on questions of corporate policy.

While officers also should keep in mind these other interests, it is primarily the responsibility of boards of directors to check on this point. There has been a tendency in recent years to include on the boards of directors of certain semipublic corporations members who are designated as “public-interest” directors. Might it not be well for the ordinary business corporation to include on its board a few members who can consistently represent the points of view of the various “publics” concerned with its operations? Recognizing the difficulty of finding those who can consistently and intelligently represent the various points of view needing to be considered, the experiment is nevertheless worth a trial. Its results might save many headaches for otherwise narrow-minded boards.

**Compensation.**—Traditionally, corporation directors are paid directly in token compensation. They usually receive a fairly nominal monthly stipend which is distributed to them at the regular monthly meeting. In at least some corporations additional compensation is paid indirectly in ways that might not always meet the approval of stockholders if they were acquainted with the facts. In fact, it has been generally assumed that many directors accept election to such positions in order to take advantage of the inside knowledge that they thereby acquire. Where directors are speculatively inclined, the advance notice they receive of changes in the prospects of the corporation enable them to capitalize on such knowledge before it becomes common property. In other cases, some directors are in a position to profit from membership on the board: such as a lawyer who receives additional fees

<sup>1</sup> Bower, Marvin, *Becoming a Director—A Business Honor or a Financial Boom-rang?* *Harvard Business Review*, April, 1931, pp. 371-382.

for legal services rendered or a banker who acts as fiscal agent and disposes of the corporation's securities. In yet other cases, a director may act in a dual capacity as director for one corporation and as agent for another which obtains some advantage from this relationship.

In recent years, some attention has been given to experiments in placing corporate directors on annual salaries large enough to enlist more than their passing interest in corporate affairs. Where such salaries have been paid, it has been with the understanding that the corporation had a right to call upon its directors for something more than attendance at monthly meetings. Also, heavy penalties, in the nature of withholding of more than a prorata share of annual compensation, have been imposed for absences from meetings or failure to meet other assignments. Many English corporations customarily pay sizable salaries to their directors.

**Officers as Directors.**—In American experience, it is not uncommon for corporate officers to be members of the board of directors at the same time. Indeed, many corporate boards are dominated by their officers. In such cases, the token fee for serving as director may be greatly overshadowed by the compensation received as an officer. Where these kinds of dual relationships exist, it is not hard to see how officers might be useful in voting salaries and bonuses for each other, even though they should not vote when their own salaries are considered. Where it is customary to distribute bonuses to officers, directors who are not officers frequently share in the bonuses. Since the publicity given to such bonuses by the Securities and Exchange Commission has caused the awakening of stockholder objections, they have tended to become more moderate in amount.

**Stock Transactions of Directors.**—Certainly no one should complain if a corporation director owned a sizable block of stock in the corporation that he serves. On the contrary, this would seem to be quite desirable. The more direct his financial interest in its success, presumably the greater the attention he would pay to its affairs. And for good and sufficient reasons, there would seem to be no objection to his purchase of additional stock or the sale of a part of his holdings. But when we raise the question of frequent purchases and sales, the answer is less certain. As already indicated, the director is in a position to capitalize his inside information and to profit from knowledge of the corporation's future prospects—good or bad.

But the director is also in a position to influence those future prospects. By his vote he can help to determine success or failure. If he is primarily interested in speculation, his prospects for personal gain may outweigh his obligations to protect the interests of other stockholders. It was with this background that Congress saw fit to require corporation officers and directors to disclose the amount and nature of their transactions in their corporation's stock. While purchases and sales are not prohibited, it is expected that

publicity of their frequency and quantity will tend to discourage too much speculation. In addition to requiring monthly reports of changes in corporate holdings, each officer and director who makes a profit from a purchase and sale of his corporation's stock within a 6 months' period is subject to having this profit taken from him and given to the corporation. Of course it is still possible to use dummy accounts if they are cleverly disguised. By removing temptation or making its use more difficult, some selfish directors may be induced to give more consideration to the trust that they have assumed in accepting election to office as directors.

**Theory of Trusteeship.**—Much has been written on the subject of the responsibility of directors and officers to the stockholders whom they represent. E. M. Dodd, writing in *Harvard Law Review*, May, 1932, page 1146, on the subject "For Whom Are Corporate Managers Trustees," says: "The directors and other agents are fiduciaries carrying on the business in the sole interest of the stockholders."

A. A. Berle, Jr. says in an article on "Corporate Powers as Powers in Trust," published in *Harvard Law Review*, May, 1931, page 1049:

All powers granted to a corporation or to the management of a corporation, or to any group within the corporation, whether derived from statute or charter or both, are necessarily and at all times exercisable only for the ratable benefit of all the shareholders as their interest appears.

At page 1050, he continues:

For years corporate papers and general corporation laws have multiplied powers and made them increasingly absolute; . . . charters have to an increasing extent included immunity clauses and waivers of "rights." It seems not to have occurred to draftsmen that, through the very nature of the corporate entity, responsibility goes with power.

Again, at page 1074, he says:

Whenever a corporate power is exercised, its existence must be ascertained and the technical correctness of its use must be checked; but its use must also be judged in relation to the existing facts with a view toward discovering whether under all the circumstances the result fairly protects the interest of the shareholders.

Many of the apparently rigid rules protecting shareholders, as, for example, the rule creating preemptive rights, are in reality not "rights" but equitable remedies, to be used, molded, or discarded as the equities of the case may require.

New remedies may be worked out and applied by the courts in each case, depending on the circumstances. . . . The powers of courts of equity in this regard are as broad as may be necessary to adjust and maintain the relative participations of the various classes of shareholders.

No form of words inserted in a corporate charter can deny or defeat this fundamental equitable control. To do so would be to defeat the very object and nature of the corporation itself.

**Powers of Directors.**—To the extent that directors are held by the courts to a theory of trusteeship, this means that they are trustees for all the stockholders as a group and not for individuals. In the exercise of their powers, they are supposed to employ good faith and to act with prudence and diligence. Each of these terms is relative. Even though an appeal should be made to a proper court to make sure that good faith, prudence, and diligence are employed, it is still possible to fall short of the ideals that might be visualized for a director's position in relation to stockholders' interests. It does not appear likely that courts would insist upon more than is usually given under similar circumstances. For that reason, a consideration of the following powers that directors usually exercise must keep in mind the degree of good faith, prudence, and diligence that would probably be required. It is clear, however, that courts will not sanction profits to directors at the expense of the corporation's stockholders where flagrant cases are brought for adjudication.

Acting in their representative capacity, the most common powers exercised by directors are as follows:

1. To adopt and amend by-laws. This may be reserved to the stockholders except for such as govern the meetings of directors. As already noted, in some cases by-laws are under the jurisdiction of directors while regulations, which have as their purpose the more fundamental internal control of the corporation's affairs, are left to the control of stockholders. As a matter of actual practice, of course, even stockholders' meetings are frequently dominated by directors. This is true for two reasons: (1) stockholders seldom attend meetings; and (2) it is natural for the stockholders to follow the leadership and advice of their directors.

2. To declare dividends. This is an exceedingly important power assigned to directors. Dividend policies may make or break corporations. Directors are not subject to stockholder control on this subject, and their discretion is seldom questioned by the courts.

3. To inspect the minutes of stockholders' and directors' meetings. Indeed, it would seem elemental to expect all directors to familiarize themselves with the contents of all such records. There might even be made a good case for making such records available under reasonable circumstances to stockholders as well.

4. To appoint committees, officers, and special agents and to designate their duties. Since the directors who are not officers of a corporation are not expected to give full time to its affairs, the selection of committees, officers, and other special agents who are expected to execute the policies outlined by the directors becomes especially important. As a matter of practice, not all such officers and agents are so selected. Frequently the president or general manager makes some of these selections. Those who are directly responsible to the board of directors are usually appointed by

them. If goes without saying that the power of appointment carries with it the power of dismissal.

5. To fill vacancies in their own body. While this power rests originally with the stockholders, it is usually given by them or by charter or statute to the directors. In the case of death, resignation, or other disability of a director, it would hardly be worth while to call a special meeting of the stockholders merely for the purpose of electing a successor. Furthermore, seldom would the balance of power in a board be upset by such appointment, since boards are usually dominated by a majority group.

6. To determine the general business policies of the corporation and to settle all questions of extraordinary significance. Within the scope of this power lies the chief reason for the existence of a board of directors. Except for the need for a working group of interested individuals to review the recommendations of the officers, we might just as well do without a board of directors. It is to be expected that the officers shall make the recommendations. But it is the function of the directors to review these recommendations and take responsibility for their approval or disapproval. If the board merely rubber-stamps the officers' proposals, it fails in its duty.

7. To call special meetings of stockholders. This power is seldom exercised. Regular meetings are provided for in the charter or by-laws. Matters that cannot wait until the time of such regular meetings are usually passed upon by the directors. In rare instances, urgent questions whose answers require the action of stockholders might necessitate the calling of a special meeting.

8. To authorize expenditures outside the usual course of business operations. In some cases, in which relatively large amounts of money are involved, even the approval of stockholders must be sought. For example, in a large expansion program or in the purchase of a competitor's assets, the stockholders might be consulted.

9. To issue stock. The amount that can be issued upon the authority of the directors must first be authorized by the state, as stated in the charter, and later approved by the stockholders. Stock may be exchanged for property without further reference to the stockholders, except where relatively large amounts are involved. In the issuance of no-par stock, the directors usually have the right to fix the price of each particular issue.

10. To ratify acts of committees, officers, and others acting under instructions from the directors. In fact the board, at a subsequent meeting, could ratify acts of its own members sitting without the presence of a quorum. And even though officers or others acted without board authority, such acts can be validated by later approval of the board. There have been instances where committees have been approved by a majority of a board of directors to deny minority interests the right to know just what is going

on. Ratification of the acts of such committees by subsequent board action in effect substitutes the judgment of the committee for that of the board.

11. To sell corporation property. Such power applies to the sale of capital assets as well as to other property. However, in case the sale covers all or a large part of the corporation's assets, its confirmation by the stockholders may be necessary before it can be consummated.

12. To make appropriations from surplus. This is for the purpose of establishing and maintaining funds and reserves of various types. Seldom is the discretion of the board of directors questioned in the exercise of this power. Since most of the purposes for which appropriations can be made are matters of judgment, both as to the quality and the quantity of the appropriation, the board of directors is presumed to be the body to exercise such judgment. The only test is the welfare of the corporation. Likewise, the disposition of the appropriations and even the abandonment of the purpose are usually left to the board, subject only to the exercise of good faith by its members.

**Common Law Liabilities of Directors.**—With all the power concentrated in the hands of corporation directors, it would appear that they should be held accountable for their acts or their failure to act. Both common law and statute law intend that such responsibility shall be placed upon directors and that they may be held individually liable for either misfeasance or malfeasance. While they are authorized to act only as a body, these acts must be approved by them as individuals voting at a meeting. As common law, directors are subject to liability for the following:

1. For loss or damage resulting from *ultra vires* acts. Presumably, some individuals who are the victims of such acts and suffer damage therefrom will bring suit to recover damages. Only in such cases can the courts even know of the existence of unauthorized acts. If no one brings suit or if allegations are not proved if a suit is brought, then no personal liability attaches to the offending directors.

2. For unlawful corporate acts committed with the approval, consent, or unprotested knowledge of the directors. *Ultra vires* acts are ordinarily legal acts, but the corporation that commits them is not authorized to perform them. Unlawful acts are punishable whether committed by corporations or others.

3. For issuance as full-paid, stock that is only part-paid. This liability is largely academic because seldom is part-paid stock used.

4. For willful or negligent payment of dividends that result in capital impairment. Any board of directors that found itself in this position probably should be punished for stupidity in addition. As will be shown later, it is so easy to eliminate capital impairment that there is no reason to be caught in this dilemma.

5. For any act evidencing gross mismanagement. As agents and trustees for creditors and stockholders, directors are obliged to exercise good faith and to give the affairs of the corporation reasonable attention. What constitutes good faith and reasonable attention is not easily defined in exact terms. Courts are likely to ask what is commonly done under similar circumstances. On the other hand, it is safe to say that courts of equity stand ready to give relief to creditors and stockholders of corporations whose directors mismanage their affairs, if only injured parties would take the necessary steps to obtain relief. Whenever suits are brought, the defendants are the individual directors whose actions or failure to act are responsible for the alleged loss or damage.

**Statutory Liabilities of Directors.**—Corporation codes impose statutory liabilities upon directors, either in addition to the common-law liabilities, or as a restatement thereof, or both. For instance, in some jurisdictions, directors are held personally liable by statute for the following:

1. Commencing business operations before the specified minimum capital has been paid in.
2. Authorizing false statements or reports with intent to deceive.
3. Declaring dividends in the absence of a surplus or paying out the capital except as provided by law.
4. Lending corporate money or credit to stockholders, officers, or directors.
5. Transferring property to stockholders or officers for the purpose of defrauding creditors.
6. Failing to act as trustees for all corporate property, in case of dissolution.

In most states, directors guilty of the above offenses may be held criminally liable also under statutes against embezzlement, fraud, and larceny. Dissenting directors can avoid penalty by properly recording their dissent from illegal actions of the majority of the board.

**Waiver of Liabilities.**—Some corporate charters depart so far from common standards in relieving boards of directors from liability for their acts as to raise serious questions about the position courts would take in defending the usual rights of shareholders, in case their assistance were solicited. For example, the Maryland charter of the Dodge Brothers, Inc., provided that a director is not liable for profits made by him in dealing with the corporation, even though he has not disclosed to his fellow directors his interest in the transaction on which he voted and which resulted in personal profits for him. The charter of the U. S. and Foreign Securities Corp. permits a director to cast a deciding vote on a resolution involving a transaction in which he has a personal interest. The charter of the Manhattan Dearborn Corp. of Delaware provides:

The corporation may enter into contracts or transact business with . . . its directors or officers or with any firm of which . . . its directors or officers are mem-

bers . . . and such contract . . . shall not be invalidated or in any wise affected by the fact that any such directors . . . have or may have interests therein which are or might be adverse to the interests of the corporation, even though the vote of the directors having such adverse interest shall have been necessary to obligate the corporation upon such contract.

**Officers.**—The line between corporate officers and other agents or employees is not always sharply drawn. Generally speaking, officers include those individuals who are the direct representatives of the board of directors and of the corporation. Usually they are responsible directly to the board. Stockholders have the original right to choose the officers, but they usually surrender such right to the board of directors.

To say that officers are appointed by boards of directors and are responsible directly to them rather than to the stockholders is a statement of a legal rule. This does not imply that officers may ignore the interests of stockholders in the performance of their duties. Instead, it is frequently necessary for the president of a specific corporation to remind his board of directors of their own responsibility as trustees for the interests of stockholders and bondholders. Failure to do so may not result in immediate dismissal of either officers or directors. But practices that ignore these interests are a part of the whole fabric of anticorporate propaganda which has been growing in recent years.

In American experience particularly, the officers of a corporation are usually in a position to dictate its policies. Boards of directors are frequently made up largely of officers or of others who are likely to follow the leadership of those who give their full time and attention to the business. Under such circumstances, it is not very convincing for a corporate officer to attempt to avoid responsibility for poor leadership by stating that he was merely carrying out the policies outlined for him by his directors. Directors and officers of American corporations are so closely related in their operations that what is said about either usually applies at least to the officers. If either goes blameless, it should usually be those directors who give little time and only infrequent attention to the affairs of the business.

The minimum offices to be filled are those of president, secretary, and treasurer. Sometimes one man assumes two offices. One secretary-treasurer is common. Occasionally we find a president-treasurer. It would hardly be possible to combine the office of president, the presiding officer, with that of secretary, the recording officer. In the larger corporations, many additions may be made to this minimum list, such as numerous vice-presidents in charge of this or that branch of operations, managing directors, general managers or superintendents, auditors, legal counsel, and special officers for various purposes. With respect to these latter, no general practice is followed. Sometimes general managers, superintendents, etc., are classed merely as employees.



**Duties of Officers.**—Title does not confer either authority or responsibility in corporate affairs. A president may be the directing head of the business; or he may be a figurehead only, while the chairman of the board of directors, the general manager, the vice-president in charge of operations, or some other officer may be the actual head. Powers and responsibilities of officers are fixed by statute, charter, by-laws, resolutions of the board of directors, or custom. Few are fixed by statute or charter. Ordinary duties result from custom, while most unusual powers are stated in the by-laws or enacted by resolution of the directors.

One observer defines the basic managerial responsibilities in the following terms: (1) operating or immediate executive responsibilities; (2) cooperating with associated managers; (3) negotiating with customers, suppliers, employees, and investors; (4) risk bearing, *i.e.*, recommending or making investments; (5) advising, applied largely to professional executives, such as engineers, chemists, etc.; (6) visualizing and developing business opportunities and techniques.<sup>1</sup>

Ordinarily, officers may not delegate powers to others. Within the limits of their authority, officers who act in good faith and use ordinary care and diligence in the conduct of the corporate business entrusted to them may not be held liable for their decisions. An officer may be held personally liable when he exceeds his authority, unless the board of directors releases him by ratifying his unauthorized actions. He may be held liable also for mismanagement, neglect, or wrongdoing, such as the dissemination of false and deceptive statements.

**Law vs. Practice.**—It is common knowledge that corporate managers find means of circumventing legal protections for security holders. By the use of practices that are entirely legal, the security holders are induced to relinquish rights that are essential to their protection. Some observers think the courts will disregard such waivers. One commentator says:

But it is clear that, when the law catches up with present corporate practices, it will be forced to disregard the fact that in many cases security holders have, through specific stipulations in contractual instruments, signed away their rights and granted the management, in effect, complete discretion to do whatever it wishes.<sup>2</sup>

Once in a while, a corporate officer is brought to book and asked to account for actions questioned by others. When the president of the Utilities Power and Light Corp. resigned in 1936, the corporation sued him for an accounting and the repayment of money and other property, amounting to \$3,000,000, which, it was claimed, he had converted to his own uses.

**Compensation of Executives.**—The number of executives employed by a corporation does not vary so greatly as the number of other employees. The

<sup>1</sup> Riegel, J. W., Some Basic Managerial Responsibilities, *Harvard Business Review*, Spring, 1935, pp. 286-308.

<sup>2</sup> Shaffner, F. I., "The Problem of Investment" (New York, 1936), p. 275.

reason is the need for retaining men in key positions if the business is to continue. Salaries of such executives are relatively inflexible and indeed tend to increase during business recessions because other sources of income are reduced. In addition to salaries, executives commonly receive various kinds of incentive payments, including cash or stock bonuses and options to buy stocks at preferential prices.<sup>1</sup>

**Bonus to Executives.**—In a study of compensation of corporation executives, 69 per cent of all corporations investigated used a salary and bonus plan of paying executives in 1928; 47 per cent of all executives received some bonus. In 1929, 62 per cent of the corporations used bonus plans, and 51 per cent of the executives benefited from them. In 1932, only 26 per cent of the corporations used bonus plans, and only 10 per cent of the executives benefited. The appreciable drop in bonus payments in the latter year resulted in large part from the automatic operation of bonus contracts which make the amount of bonuses contingent upon the amount of net earnings or some similar test of performance. Some bonuses are paid regardless of dividend declarations. With sharply decreased operations, the drop in bonus payments follows. Some corporations abandoned the bonus plan during the depression. As a result of decreases in bonus payments, offset in part by increases in salaries, the total compensation of all executives studied was 59.6 per cent as great in 1932 as in 1929. The largest reductions are accounted for in the compensation of the highest paid executives.<sup>2</sup>

A wide range of corporations uses some form of bonus as part compensation for their executives, including American Rolling Mill Co., Atlas Powder Co., Consolidated Laundries Corp., First Boston Corp., General Time Instruments Corp., Lorillard Co., McCrory Stores Corp., Paramount Pictures Corp., Porto Rican-American Tobacco Co., and U.S. Rubber Co.

**Manipulation Invited.**—Many bonus plans do not have the approval of stockholders. They may ask equity courts to review such plans, but they seldom do. One reason for their opposition is their fear of unwarranted payments, due to the control which the recipients of bonuses have over the amounts that they receive. At best, earnings are not easily defined. Manipulation of accounts can be effected to the advantage of executives in several ways: (1) by making the profit upon which the bonus is based appear larger than it really is; (2) by juggling charges to and credits from subsidiaries to the same end; (3) by having the corporations that they manage contract with the executives, thereby affecting profits; (4) by manipulating the amount of the income stream flowing to certain security holders; (5) by tampering with surplus accounts; (6) by manipulating no-par stock, rights, and warrants; (7) by influencing the dividend policy with respect to

<sup>1</sup> See Chap. XVI.

<sup>2</sup> Baker, J. C., and W. L. Crum, *Compensation of Corporation Executives—The 1928–1932 Record*, *Harvard Business Review*, Spring, 1935, pp. 321–333.

noncumulative preferred stock; (8) through purchase and sale of securities, thereby determining the amount of income going to certain security holders.<sup>1</sup>

**Proportion of Earnings Paid to Executives.**—One estimate indicates that, in 1929, executives were paid an average of 6½ per cent of net earnings, this term being defined as the net income of the corporation before the payment of executive compensation and bond interest. The same authority states that there is no substantial statistical evidence to support the claim that executives who receive a high percentage of earnings either produce results that are reflected in unusually high earnings or in decreased fluctuations in earnings.<sup>2</sup>

For the year 1936, the total executive compensation for the General Motors Corp. was equal to \$0.24 a share on its common stock, of which \$0.07 represented a bonus. In 1935, the executive compensation was only \$0.18 per common share. In 1936, the executive compensation amounted to \$0.03½ per \$1 of total pay roll.

**Ownership vs. Management.**—Flexibility in corporate management is in inverse proportion to the size of the organization and the number of people involved. With the growth of large-scale business units and the development of huge corporations to manage them, the breach between ownership and management becomes ever wider. As already indicated, the powers of stockholders are few and their opportunities to exercise them infrequent. For the most part, boards of directors are self-perpetuating. Once in control, the proxy ensures their succession in office. The introduction of nonvoting stock did not change matters. It merely recognized and crystallized a condition already existing. (Both the New York Stock Exchange and the New York Curb have refused to list any more nonvoting common-stock issues.) Furthermore, American security owners are not only stock-minded, but they are speculatively minded. A depression only chills but does not kill speculative desires. Many stockholders are not interested in the management of the corporation whose shares they own. They are not even primarily interested in the dividends that they receive. Their main interest is in the rise in price of their stock. If they belong to the number who do look on their stock as an investment instead of a speculation, then their interest is centered upon the regular receipt of as large a dividend check as possible. They are glad to leave the management in the hands of a board of directors, about whom they know little.

**Close Corporations.**—The only corporations whose conduct is governed by informality of actions are incorporated partnerships and other close corporations, where stockholders are directors and directors are officers—in other

<sup>1</sup> Nerlove, S. H., *Insiders and Corporate Income Streams*, *Accounting Review*, June, 1930, pp. 153-156.

<sup>2</sup> Baker, J. C., *Executive Compensation Compared with Earnings*, *Harvard Business Review*, Winter, 1936, pp. 213-224.

words, where there can be no separation among ownership, control, and management because all three are centered in the same personalities. Here decisions, business conduct, apportionment of profits—all take place by common consent without at times even the formality of votes. Only the relations with governmental bodies must be kept in due form.

**Voting Trusts.**—Should there be any question about continuity of control of a corporation, particularly during a critical period of its history, the end desired can be attained by an agreement to place control in the hands of a voting trust for a specified period of time or until specified objectives are reached. The voting trust originated in 1864 and has had wide use since. Stockholders assign their shares to the trustees and receive in return voting-trust certificates which carry all the rights of stock except the voting right, which is retained by the trustees. The holders of certificates of beneficial interest in the Great Northern Iron Ore Properties have no voting power but only ownership equity in the properties controlled by the trust. They are entitled to their prorata shares of distributions made by the trustees. The trustees elect the directors of the companies controlled by the trust. One of several conditions is usually present to justify the formation of a voting trust:

1. The group of stockholders in control of a corporation at any time may wish to ensure the continuation of such control until defined objectives are attained. By the organization of the trust, this is assured, regardless of the later change of attitude of stockholders or, indeed, of change in ownership, since voting-trust certificates and not stock would change hands. In 1931, the stockholders of the American Water Works and Electric Co., Inc., formed a voting trust of two members with a life of 5 years to ensure the continuation of the existing management. The power of the trustees was limited to the election of a board of directors of the corporation. In order to maintain continuity of management policies, the Sperry Corp. established a voting trust expiring in 1943. The trust agreement provides for the retirement of any trustee by the unanimous action of the other trustees and for the replacement of any trustee by a majority vote of the remainder. There are five trustees.

2. Stockholders of a financially embarrassed or of a reorganized corporation may wish to preserve continuity of management until greater stability is attained. The voting trust is the vehicle used to reach that point.

3. The law may create a voting trust to make sure that a judicial decree requiring definite action by the stockholders of a corporation will be put into effect.

4. Internal dissension in the management of a corporation may result in temporary trusteeship. The Federal court, having jurisdiction over the Philadelphia Rapid Transit Co., appointed six trustees to manage its affairs because of inability of those in control to agree upon an operating policy.

5. Occasionally the administration of a voting trust is so satisfactory that it is continued even after its original purpose has been served. When the voting-trust agreement of the Rio Grande Valley Gas Co. expired by limitation of its terms in 1937, holders of both voting-trust certificates and common stock asked that the trust be continued for a period of 10 years. The operation of a voting trust may exhibit little variation from the operation of the usual board of directors. "Business as usual" may be the slogan of the trustees. The trustees operating the Columbian Carbon Co. paid dividends—regular and extra—on the voting-trust certificates; engaged in a merger, exchanging certificates for the shares of the company absorbed; and gave their owners the right to subscribe for new certificates at the ratio of one for each six held.

6. The voting trust may be used to maintain control by the "dead hand." The will of Cyrus H. K. Curtis, founder of the Curtis Publishing Co., provided for a voting trust for his holdings of stock in this company, to remain in existence until the death of the last survivor of his grandchildren. During the continuance of the trust, the common stock may not be sold "unless some extraordinary contingency shall arise making it desirable to sell and then only in the event that my trustees unanimously agree."

7. Voting trusts are sometimes established to dispose of the stock that they control. In February, 1927, a voting trust of the Southern Berkshire Power and Electric Co. was created for the purpose of obtaining \$100 per share within the first 5 years or \$125 per share within the next 5 years. In June, 1927, the Massachusetts Utilities Associates acquired a controlling interest in this company. The common shares of the Massachusetts Utilities Associates are deposited under a voting-trust agreement whereby they may be sold at \$75 before 1937, and thereafter at \$100 to 1947. The voting trust of the Huntingdon and Broad Top Mountain R.R. and Coal Co., holding a majority of both preferred and common stock, have the right to sell preferred stock in one block at \$50 per share and common at \$25.

**Legal Authority for Voting Trusts.**—Statute law expressly sanctions voting trusts in but few states. The first statute on voting trusts was enacted in New York in 1901. This provided a limitation of 5 years, which set the standard for other states. The New York limitation was extended to 10 years in 1923. A few other states have specifically provided by law for voting trusts, some for periods longer than 10 years.<sup>1</sup> Court decisions in other states favor such arrangements, provided that the trust is for a proper purpose and for a reasonable period of time. Some courts consider the device objectionable. In a 1915 decision, the Supreme Court of Illinois said:

The power to vote for directors can be exercised only by stockholders in person or by proxy, and they cannot be deprived or deprive themselves of this power. . . .

<sup>1</sup> Cushing, H. A., "Voting Trusts" (New York, 1927), pp. 22-23.

A stockholder may refuse to exercise his right to vote and participate in stockholders' meetings, but he cannot deprive himself of the power to do so.<sup>1</sup>

**Limitations upon Trustees' Power.**—Some voting-trust agreements impose limitations upon the discretion of the trustees in dealing with such questions as sale of assets and issuance of additional securities. In some other cases, where the agreement does not contain such restrictions, the trustees nevertheless refer such questions to the stockholders for advice or decision. The trustees under the voting trust of the Manville Jenckes Corp. may not vote for or consent to any amendment in the company's certificate of incorporation creating any new class of stock, changing the amount of authorized stock, or changing the preferences or special liens of any class of outstanding stock without the consent of the holders of the certificates representing at least 51 per cent of the shares of stock, taken together as one class, held by the trustees. The trustees may not vote for or consent to liquidation, consolidation, merger, or sale of all, or substantially all, of the corporation's assets without the consent of the holders of 51 per cent of the voting-trust certificates. The voting-trust agreement of the Dorset Hotel Corp. provides that the trustees shall vote for two directors nominated by the parent company and for the third to be nominated by the bondholders and approved (or nominated) by the court to represent the bondholders. The entire capital stock of the 810 South Spring Building Co. (Los Angeles) is held by three trustees under a voting trust agreement to run for 21 years from 1936. The trustees may not sell the property or, within limits, lease, mortgage, convey, or encumber it without consent of the holders of at least one-half of the outstanding bonds and certificates.

In some cases, the limitations are of a character to raise questions about the real nature of the trust relationship. All stock of the National Bondholders Corp. is held by voting trustees who agree "to vote the stock upon such matters as shall require the vote of stockholders, in accordance with the express wishes of holders of participation certificates so far as those wishes shall be indicated in writing."

**Termination of Voting Trusts.**—Voting trusts may be terminated in any of the following ways:

1. By the expiration of a specified term of years. All stock of the San Diego El Cortez Corp. is held under a voting trust agreement to run for not more than 21 years. In 1877, the stock of the Pittsburg and Lake Erie R. R. was placed in a perpetual voting trust, which was overthrown a decade later by the courts.

2. By the vote of the certificate holders. Three years after the date of the voting-trust agreement of Gaylord, Inc. (Los Angeles), and, if necessary, at least every 2 years thereafter, holders of voting-trust certificates

<sup>1</sup> *Luthy v. Ream*, 270 Ill. 170 (1915).

will vote either to continue or to terminate the trust. The voting trust of the Huston Oil Co. of Texas has no terminating date but may be dissolved when two-thirds of the holders of voting-trust certificates request such action. Meantime, holders have a right to vote their stock upon written notice to the trustees.

3. By the happening of a specified event. In 1936, the shareholders of the Tomahawk Kraft Paper Co. formed three voting trusts representing respectively, Class B, Class C, and common stock. The agreements provide that if a default occurs in the payment of interest on the company's first mortgage 6s, for three consecutive 6-month interest periods, the voting trustees shall surrender all stock held by them. Each trust terminates on the retirement of the company's first mortgage bonds. The voting trust of the Penn Glass-Sand Corp. holds all its common stock except directors' qualifying shares. This trust will terminate after the retirement of all the first mortgage 6 per cent bonds: (1) on demand of the holders of two-thirds of the outstanding 7 per cent preferred stock; (2) when the shares of such preferred stock have been retired; or (3) when no voting stock is held by the trustees because of a merger, consolidation, or sale of the company's assets.

4. By the sale of the assets.

5. By the exercise of terminating discretion vested in the trustees. All common stock of the Hecker Products Corp. is held by a voting trust organized to ensure continuity of management policies of the company. The trust may be terminated at any time by the trustees.

**Tendencies in Control and Management.**—A recent study of 42 railroads, 52 public utilities, and 106 industrials, composing the 200 largest American corporations at the beginning of 1930, whose combined wealth amounted to nearly half the nonbanking corporate wealth of the country, showed the following concentration of control:<sup>1</sup>

Type of control	Percentage distribution	
	By number	By wealth
Management control.....	44	58
Legal device.....	21	22
Minority control.....	23	14
Majority control.....	5	2
Private ownership.....	6	4
In hands of receiver.....	1	Negligible
	100	100

<sup>1</sup> Berle, A. A., Jr., and G. C. Means, "The Modern Corporation and Private Property" (New York, 1933), p. 94.

According to this study, only 11 per cent of these companies, owning 6 per cent of the total wealth of the group, are controlled by more than half their ownership; while 65 per cent, owning 80 per cent of the wealth, are controlled directly by management or through legal devices such as are discussed later in this text. The same study quotes the *New York Times* to the effect that in 1928 the total number of shares of stock owned by the directors of the U.S. Steel Corp. amounted to but 147,794.<sup>1</sup> Since there was outstanding at that time a total of 10,719,046 shares of voting stock, the management of the corporation, represented by its board of directors, owned collectively but 1.4 per cent of the voting stock. The combined capital stock and surplus of the American Telephone and Telegraph system at the end of 1936 was \$3,647,907,000. Book value of total assets was \$5,149,304,000. It has more stockholders than any other corporation in the world—640,991 at the end of 1936. No holder owns so much as 1 per cent of the total outstanding stock.

Another study showing the small percentages of voting stock held by officers and directors of a selected group of corporations discloses the following results:

VOTING SHARES HELD BY OFFICERS AND DIRECTORS,<sup>1</sup> DECEMBER 31, 1934

Name of corporation	Assets (000,000 omitted)	Percentage of voting stock held by officers and directors
American Car and Foundry Co.....	\$ 90	0.46
American Smelting and Refining Co. . . . .	208	0.62
American Sugar Refining Co.....	120	0.48
American Tobacco Co.....	280	0.43
American Woolen Co.....	64	0.58
Anaconda Copper Mining Co.....	522	0.61
Curtiss Wright Corp.....	28	0.10
General Electric Co.....	382	0.78
Ohio Oil Co.....	170	0.70
Standard Oil Co. of California.....	575	0.26
Standard Oil Co. of Indiana.....	657	0.22
Standard Oil Co. of New Jersey.....	1,104	0.37
Westinghouse Electric and Manufacturing Co.	181	0.25

<sup>1</sup> Reis, B. J., "False Security; a Betrayal of the American Investor" (New York, 1937), pp. 11-16.

### QUESTIONS AND SUGGESTIONS

1. Could you become an incorporator in the state in which you are now living? If not, why not?
2. What subjects form the content of corporate charters?

<sup>1</sup> *Ibid.*, p. 87.



3. Are *ultra vires* acts illegal? Explain.
4. What are the purposes of corporation by-laws? Who are responsible for their enactment?
5. State and account for the position occupied by stockholders in what the English call public corporations.
6. By what procedure may a stockholder see that his rights are protected? Which rights are most commonly used?
7. Just what is meant by the right of stockholders to inspect the books of the corporation?
8. May directors vote by proxy? Why?
9. What are the qualifications of corporate directors? Do you approve the suggestion of "public-interest" directors? Why?
10. Contrast English and American experience in compensating corporate directors. Which do you prefer, and why?
11. What are the pros and cons of electing officers to boards of directors?
12. Why are objections raised against the practice of corporation directors speculating in the stock of their own corporations?
13. What is the theory of trusteeship as applied to corporate directors? To what extent is it enforced?
14. List the most important powers of directors.
15. What are the liabilities of directors? What is meant by a waiver of liabilities? What is the effect of such action?
16. Distinguish between officers and employees. How are the duties of each determined?
17. How are officers compensated? What objections are sometimes raised against current practices in determining their compensation?
18. What is a close corporation? State several examples.
19. What are voting trusts, and why are they used? How may they be terminated?
20. What conclusions do you draw from the Berle and Means study of America's 200 largest corporations?
21. Is the small percentage of stock sometimes owned by officers and directors a cause for alarm? Or is it merely evidence that management is becoming more professionalized?

#### SUPPLEMENTARY READINGS

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- OWENS, R. N.: "Business Organization and Combination" (New York: Prentice-Hall, Inc., 1940), Chap. X.
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**SUBJECTS FOR INVESTIGATION**

1. Interview some one who has owned stock in a corporation and list what this individual thinks are (a) his rights as a stockholder, (b) his duties, (c) his liabilities. Grade his answers, giving attention to his omissions as well as his errors.

2. Construct a chart, showing the relationships among the constituent parts of a corporation.

3. What does the law of your state say on the question of the theory of trusteeship as applied to corporate directors?

## PART II

# CORPORATE SECURITIES

### CHAPTER VI

#### COMMON STOCK

**Need for Definitions.**—Corporation finance deals first with stocks and bonds. In fact, in the earliest discussions of the subject, little was included except stocks and bonds. In spite of the inclusion of a great deal more material in this text, much that will be discussed in succeeding chapters will assume a knowledge of the various types of securities used by corporations. For this reason, it is necessary that some attention be given to the subject of definitions.

**Origin of Stock.**—The first business corporations divided the evidences of ownership into shares and allotted to each owner his proportionate part of the enterprise. English practice still provides a method, long since forgotten in American experience, of distinguishing between stocks and shares. Stock is transferable in any amount; shares are always expressed in certain definite multiples, as a £5 share. Stock is always registered; shares may be registered or may consist merely of bearer scrip. At the outset, when only one class of stock was used, it was usually designated as stock without any qualifying adjective. Or, in some instances, it was called "capital stock." Both "stock" and "capital stock" are still commonly used by corporations that have only one class of stock outstanding. Whenever either of these names is used, it may be assumed that it has practically the same meaning as common stock discussed in this chapter. With the development of classes of owners with different degrees of risk, income, and control, it became necessary to distinguish one class from another. This gave rise to the variety of names now employed, particularly in English and American corporate practice.

**Definition of Common Stock.**—Common stockholders are the residual claimants against the assets and income of the corporation. They are entitled to what is left after all prior claims have been satisfied. Should there be only one class of stock outstanding, it is usually common stock, although there are exceptions, in name at least, to this rule. In the early years of the Great Northern Ry. Co., its authorized stock consisted of both common and preferred. In 1890, it reacquired its outstanding 4,742 shares

of common and has had only preferred outstanding since. In 1935, it changed the latter from \$100 par to no-par. Shares of stock represent proportionate interests in the residual ownership of the corporation. They may represent also contributions to the capital of the corporation. These contributions should not always be taken too seriously, since much common stock represents merely anticipated future profits and is distributed rather freely to promoters, bankers, and others without giving to the corporation in return anything more than somewhat ethereal services.

Common stock ordinarily is supposed to have no special privileges or rights. But since limitations are sometimes placed upon other classes of stock, the result is that in some respects common stock may really be preferred. This is particularly true of voting privileges, where only common stock possesses this right. Through charter or by-law provisions, even common stock may be denied some of the rights assumed for it by law.

The residual position of the common stockholder may result to his advantage in times of prosperity and to his disadvantage when the business tide runs in the opposite direction. If the corporate payments to all other claimants are limited in amount by contract, any excess earnings accrue to the advantage of the common stockholder. Even though such amounts are not distributed in the form of dividends, the holder of the common stock may benefit from an increase in its price. Particularly in periods of booming stock prices, the paper profits of common stockholders multiply quite rapidly. Of course these may never become actual profits unless the stock is sold at a high price. If it is carried into a succeeding depression, paper profits melt away as rapidly as they previously accumulated. Also it should be noted that, in periods of low earnings, the holders of common stock may find their chances for dividends wiped out if there are fixed charges to be met in satisfying the holders of superior claims against the corporation. This suggests that the holders of common stock are always in the position of speculators, whose fortunes rise and fall with the affluence of their corporation and with the general state of business psychology. As a matter of fact, common stockholders are frequently thought of as the contributors of the "venture" capital of the corporation.

Various qualifying adjectives are used in corporation finance to describe more closely particular stock issues. Definition of these terms at this time will aid the reader to understand what follows.

**Authorized Stock.**—While boards of directors have the power to issue stock from time to time, they are limited by the charter and by the action of the stockholders. The charter fixes the maximum amount of stock that may ever be issued by the corporation—unless the charter is amended. This is called the "authorized stock" of the corporation. The stockholders may approve the issuance of less than the maximum amount fixed by the charter.

**Issued Stock.**—Only a part of the amount of stock authorized may ever actually be absorbed by stockholders, either by purchase or by exchange of property and services. Various conditions impose this limitation. Such stock as becomes the property of owners is called “issued stock.” Unissued stock is the potential stock which the corporation is authorized to issue but which has not yet been disposed of.

**Outstanding Stock.**—Of the amount of stock issued, a part may, by various means, again become the property of the corporation. The remainder, *i.e.*, the issued stock minus that which is returned to the corporation, is called “outstanding stock.”

**Full-paid Stock.**—When the corporation has received for its stock in cash, property, or services the equivalent of par, or stated value, it is “full-paid.” When only a part of the par, or stated value, has been received by the corporation, the stock is “part-paid.” Usually certificates are not issued until the stock becomes full-paid. Full-paid stock obtained in good faith is nonassessable; *i.e.*, it is free from all liability for further payments whether the corporation succeeds or not. Part-paid stock is subject to assessments up to the par or stated value. The statutes of California and Ohio permit corporations in financial distress to sell stock at a discount without imposing additional liability on its purchasers. The courts in most other states accept this doctrine. In case of insolvency, creditors may take action to collect unpaid installments. With the declining use of par stock, part-paid stock is not so commonly used as formerly. Of the stocks of 38 companies whose properties were leased by the Philadelphia Rapid Transit Co., approximately one-half were only part-paid at the time the leases were made. One of the rare corporations that recently carried part-paid stock on its balance sheet is the Premier Trust Co. (of Canada), which in 1936 had outstanding 5,585 full-paid shares, par \$100, and 2,067 shares indicated as partly paid. On the balance sheet of the Ogilvie Flour Mills Co., Ltd., a Canadian corporation, appears the item “rest account,” representing the uncalled portion of part-paid stock.

Mining stocks are sometimes subject to assessment. The capital stock of the Goldfield Development Co. has a par value of \$0.05. This stock is subject to assessment. Up to 1936, 14 assessments, totaling \$0.21½ per share, had been levied against it. Because of mine closing in 1934, due to a strike, an assessment of \$0.05 per share was levied by the Central Eureka Mining Co. on its noncumulative preferred stock, par \$1, and on its common stock, par \$1. Three additional assessments of \$0.05 each were levied on both classes of stock from November, 1936, to March, 1937.

**Treasury Stock.**—Stock lawfully issued by a corporation for money, property, or services, and later reacquired through donation or purchase, becomes the property of the corporation and may be kept in its treasury with other assets. It is called “treasury stock.” Such stock may be sold

for any price and under any terms acceptable to the corporation. Even though sold at a discount, it does not subject the purchaser to any additional liability on that account. Treasury stock frequently originates in the following manner. One of the organizers is given a large block of stock in exchange for property or services. He then returns a part of this stock to the corporation as a gift or for a nominal payment. It is now treasury stock, subject to such disposition as the board of directors may determine. By this means, the obligations placed upon the holders of par stock are largely evaded. Treasury stock is sometimes given away with the purchase of other securities. In such cases, it is called "bonus stock."

**Right to Acquire Stock.**—In the United States alone, a corporation seems to have, with the sanction of majority stockholder approval, the privilege of reacquiring, by purchase, stock it has once issued. In 1933, one study found the following statutory limitations on the purchase by a corporation of its own shares:

Type of Provision	Number of States
Not allowed .....	2
Allowed from surplus only .....	11
Allowed if capital not impaired .....	8
Allowed under specified restrictions .....	3
Allowed without statutory limitation .....	6
No statutory provision .....	18
Total .....	48

**Reasons for Acquiring Own Stock.**—Taking advantage of the prevailing low prices of their stock in the early 1930's, numerous corporations made purchases of both their preferred and common shares. Reasons assigned in their annual reports include "use of surplus cash," "reducing the capital structure to conform to present-day capital requirements," "profitable investment for the company," "reducing dividend requirements," and "providing shares for corporate use." Careful analysis of the above assigned reasons raises interesting questions about the rights of creditors and particularly of the stockholders, whose ignorance of future possibilities leads to a desire to sell when stocks are unreasonably low.

**Market Support.**—An unusual argument in support of stock acquisition by the issuing corporation was announced by the Transamerica Corp. It was claimed that owing to market conditions induced by strikes and other labor troubles and to the "undue pressure" on its own stock, it was necessary for the corporation to buy its own stock "to protect the interests of the stockholders." If all the stockholders took such an announcement seriously, the result would have been a relief of the pressure without the acquisition of any stock by the corporation. If the holders felt that the corporation

would effectively support the market for its stock, less stock would be offered for sale.

Support of the market is unobjectionable if undertaken by large stockholders on their own account or by friendly banking interests. If the corporation assumes the responsibility through the method of purchase by a third party on the corporation's account or by a subsidiary, the effects are the same as if the purchase had been made directly.

**Legitimate Acquisition Causes.**—The corporation may legitimately acquire its stock through a bona fide gift; in the process of liquidating a debt owed by a stockholder, whether through forfeiture of shares not fully paid for or otherwise; in a compromise to prevent loss; and in a reasonable bona fide purchase on account of third parties, such as its own officers and employees, provided that it uses only earned surplus for this purpose and is in a position to protect itself against loss. These purchases might better be arranged through outside parties. All such acquisitions differ from the practice of using corporation assets to speculate in its own stock. The New York Stock Exchange recognizes this difference in the restrictions it has placed upon stock-purchase practices of the corporations whose shares are listed with it. Restrictions imposed by the Securities and Exchange Commission have the same objective.<sup>1</sup>

**Arguments against Stock Acquisition.**—The arguments against the policy of corporations buying back their own stock, whatever may be their legal rights, are legion. Among the most common are the following: Repurchase of the corporation's own stock is not necessary to carry on the business for which the corporation was organized. Such purchase constitutes a breach of the fundamental agreement between the corporation and the state and among the shareholders. Such purchases reduce the funds available for the protection of creditors. They afford to corporate managements a means of giving preference to favored stockholders. Where stock purchases by a corporation are nonratable, the relative status of remaining stockholders is disturbed. Purchases enable the insiders to keep themselves in power. The influence of the majority is perpetuated and strengthened by stock purchases. A controlling minority interest may change itself into a majority interest by purchasing at least a part of the shares of the original majority. Consequent readjustment of voting strength may injure the small non-assenting holder. Stock purchase dissipates cash and delays payment of dividends to the remaining stockholders.<sup>2</sup>

It is not always easy to trace the real motives behind the practice. Insiders may use corporate funds to their own personal advantage. It is possible that the estimate of market conditions by those in control may

<sup>1</sup> Nussbaum, A., Acquisition by a Corporation of Its Own Stock, *Columbia Law Review*, November, 1935, pp. 971-1006.

<sup>2</sup> Briggs, L. L., Treasury Stock and the Courts, *Journal of Accountancy*, September, 1933, pp. 171-199.

be wrong. What they consider a new low price for the stock at the time of purchase may later prove to be an old high. In such case, dissipation of cash for the purpose of stock purchase may jeopardize the interests of the corporation's creditors, weaken its credit standing, and fail to give the desired support to the market.

**Stock Tenders.**—Where corporations reacquire their own stock, the methods commonly used are various. Stock may be purchased in the open market; it may be bought from a stockholder who offers it for sale; or it may be acquired by a method known as "tender." This involves an invitation to sell, tendered by the corporation. For example, in 1934 the American Agricultural Chemical Co. notified its stockholders that it had \$3,000,000 that was available to purchase its own stock at prices not to exceed \$35 per share. Within 3 weeks sufficient stock was offered to exhaust the available funds. The range of quoted prices for this stock in 1934 was \$25¼ low and \$48 high.

In purchasing stock offered in response to an invitation of this character, the corporation indicates the amount of money available for the purchase of stock and the maximum price it will pay. The needs and desires of the individual stockholders will determine their asking prices for their stock. Some will not care to sell, even at the maximum price quoted. Others may be so anxious to dispose of their stock that they will take less than the maximum to make sure of a sale. Naturally the corporation will buy first the stock that is offered at the lowest price, where there is a difference in asking prices. This may result in paying different prices to different stockholders at the same time. It is to be expected, however, that the maximum price set by the corporation will tend to become the asking price for stock offered for sale to the corporation.

Some corporations use the stock tender as a means of gradual liquidation. In October, 1931, the stockholders of the Simms Petroleum Co. were offered the right to sell to the corporation, at \$6 per share, one-eighth of their \$10-par shares. In January, 1932, the company offered to buy one-seventh of each holder's stock at \$5 per share. In June, 1935, the stockholders voted to liquidate the corporation. In other cases, the corporation pursues a policy of acquiring its own stock, as opportunity presents, without any definite purpose other than to reduce the outstanding stock when surplus cash permits. By 1936, the Firestone Tire and Rubber Co. had reacquired approximately one-seventh of its common stock and a like amount of its preferred. In 1933, stockholders of the Cleveland Worsted Mills Co. authorized its management to use the proceeds from the sale of obsolete property to purchase its own stock whenever prices asked were advantageous.

**Speculation in Stock.**—Some corporations take advantage of depressed prices to speculate in their own stock. Not all such operations result



satisfactorily. In such cases, questions are raised about the business judgment of the management. On the other hand, some stock purchases are followed by sales at enormous profit. For example, in 1936 the Lima Locomotive Works, Inc. sold at a profit of over 200 per cent 12,200 shares of its treasury stock acquired during the preceding depression years at an average cost of \$20 per share. In the early part of 1937 an additional 29,200 shares, acquired at an average cost of \$18.50 per share, were sold at a profit of over 250 per cent. To be sure, this was an unusual case. At the depth of the depression, this stock sold at a price less than the prorata value of the cash and government bonds in the treasury of the corporation. Why should it not use a part of this cash to make a profit? Or, when its stock followed the general downward trend of the stock market, should its management have notified its stockholders of the situation, pointing out to them the ridiculously low prices to which its stock was falling? The speculative profits gained by the corporation through transactions in its own stock might have offset the losses suffered by panic-stricken stockholders who sold out at the depth of the depression.

**Accounting for Treasury Stock.**—If reacquired stock is to be considered as an asset to be disposed of at a later date, it should be considered as stock issued and still outstanding and therefore an investment asset of the corporation that holds it. In practice it is variously carried, both as an asset and as a deduction from an equity account. In various instances, treasury stock is carried as a current asset, an investment asset, or an unclassified asset. In other cases, its value is deducted from earned surplus, stated capital, aggregate net worth, or various combinations of individual elements of net worth. Even the valuation of treasury stock lacks standardization. It may be the cost of acquisition, the original issued price of the stock, or an assigned value based upon a fractional portion of the capital-stock value.<sup>1</sup>

If, on the other hand, treasury stock is not to be considered as an asset, it should be canceled, and the capital values assigned to such stock should be deducted from the proper balance-sheet items.

By careful manipulation of the accounts, a corporation may show a book profit through the purchase of its stock on both rising and falling markets. If the market rises after the stock is purchased, a resale will result in a profit. If the market falls after stock has been purchased below par or book value, a cancellation of the stock purchased will show a book profit.

**Stock Values.**—Much confusion arises over the concept of stock value because different persons using the same word mean by it different things. In order to avoid this confusion, it is necessary to use qualifying adjectives that are descriptive of the conditions determining the particular kind of value in mind. The most common kinds of such values are the following:

<sup>1</sup> Bowles, H. G., Treasury Shares on Balance Sheet, *Journal of Accountancy*, August, 1934, pp. 98-105.

1. *Par Value.*—The par value of stock is the amount stated on the stock certificate. The par value of the common stock of Keith-Albee Orpheum Corp. is \$0.01. In some states, any amount may be used as par. Because of the common practice of exchanging stock for property or services, par value should not be taken too seriously. It may mean much or little. Seldom would par value measure anything other than the formal statement on the stock certificate. Because of the importance of the subject, a discussion of no-par stock is reserved to a later chapter.

2. *Book Value.*—Book value of stock is an arithmetical concept obtained by dividing the net worth of a corporation—as recorded on its books of account—by the number of shares of stock outstanding. The net worth is the excess of total assets over total liabilities, exclusive of capital stock and surplus. If preferred stock has been issued, its par or stated value must be subtracted also in arriving at the book value of the common stock. The analyst of most corporation balance sheets will do well to discount book values, since assets are sometimes overvalued or liabilities understated, or both. Book values alone are seldom reliable guides to anything other than the arithmetical concept stated above.

3. *Market Value.*—In a freely competitive market, where “able and willing buyers, not forced to buy, meet competent and willing sellers, not forced to sell,” stock prices should be fixed at real values. Occasionally, perhaps, such a meeting takes place. Probably the market for U.S. Steel stock, for instance, as nearly approaches the realization of the ideal competitive price as one could imagine. The “technical” position of the market, general business conditions, credit supply, and various other factors must be considered, however, so that the market price of most stocks may reflect at a particular time something other than so-called “real value.”

In effect, the market value reflects the balance of forces of prospective buyers and sellers at a specific moment of time. The nature of the balance may vary greatly from time to time. When there are many sellers and few buyers, an order to sell “at the market” may be executed several points down from the level at which the price stood a few minutes previously when the order was placed. An order to buy “at the market” when stocks are advancing rapidly may result in a purchase price considerably above the price anticipated by the purchaser. Furthermore, market value tends to place a price tag upon only the floating supply of the stock. When the market price is low, it does not tempt the satisfied stockholder to dispose of his stock. This does not deny that a continuous drop in price may not influence the attitude of stockholders toward their holdings. On the contrary, the lower a stock price falls, the more apprehensive holders of that security become. Likewise, a rising market will induce many purchasers, who have hesitated to make a commitment to buy at one price, to take the plunge and buy the same stock at a considerably higher figure.

4. *Real Value*.—Real value is the promise of things hoped for but seldom attained. It might be described as book value under conditions of absolute truth and accuracy; as market value under normal conditions, whatever that may mean; or as the capitalization of properly anticipated earnings at proper rates. The hedging terms used in these definitions are unavoidable. They indicate that stockholders who are in a position to hold their stock indefinitely have an indefinable feeling that the real value of stock is not measured by its par label, its market price, or its book value, but that some combination of these values, plus others less easily described, should give the real measure of the worth of the stock of a particular corporation. Perhaps someday when accountants become more skillful, boards of directors more faithful to their trust, and stockholders more intelligent, we shall be able to bound real value of stocks.

A few illustrations on this page and the one following will indicate the absence of direct relationship among these values. In each case, cents are omitted from the tables except for earnings per share.

ERIE R.R. COMMON STOCK  
(Par value \$100)

Year	Book value	Earned per share	Dividends	Stock prices	
				High	Low
1930	\$122	\$1.07	None	\$63	\$22
1931	121	(d)2.29	None	39	5
1932	119	(d)3.77	None	11	2
1933	119	(d)1.34	None	25	3
1934	118	(d)2.09	None	24	9
1935	117	(d)2.25	None	14	7
1936	118	(d)0.24	None	18	11
1937	118	(d)8.82	None	23	4
1938	68	(d)2.65	None	6	1
1939	65	(d)1.68	None	3	1
1940	64	(d)1.97	None	1 $\frac{3}{4}$	$\frac{5}{8}$
1941	Reorganized				

(d) means deficit.

**Watered Stock.**—Much has been written on the subject of “watered stock.” A stock is said to be watered when its true value is less than its book value. Market value has no bearing upon the concept of watered stock. The quoted price of a given stock may be high or low, depending upon the estimate placed upon its value by interested purchasers and sellers, which in turn may be a reflection of their attitude toward general business conditions rather than toward the prospects for the corporation in question. Also there should be eliminated from our thinking the implication that water

comes only from a pump manipulated by crooked promoters. To be sure, water may come from this source. Whenever so-called "full-paid stock" is issued for less than its par or stated value, it undoubtedly contains water. In nearly all such cases either property or services are exchanged, in part at least, for the stock. It might be difficult to determine the existence of an intent on the part of promoters to deceive the purchasers of the stock. If they have merely exercised faulty judgment, the stock is watered nevertheless, but recovery may be denied any who protest. If intent to defraud can be proved, then of course judgment can be had against the offenders because all corporation laws assume that stock may be disposed of only for commensurate value.

With the best of intentions, a corporation may arrive at a condition that indicates watered stock. Suppose par stock is sold for cash at par. Suppose also the corporation fails and impairs its capital by absorption of operating losses. Its stock is now watered as much as if crooked promoters set out to deceive the unwary investors by selling them stock for more than its true value.

On the other hand, corporations with waterlogged stock may, if successful, plow back future earnings in such manner as to absorb all the water and leave such corporation's stock high and dry. But suppose a corporation declares dividends from fictitious surpluses, created by a stroke of the pen, instead of from accumulated earnings. Again, we may have watered stock as a result. Those responsible are punishable for such practices, and recovery may be had by interested parties if action is taken in time. Courts of equity stand ready to protect stockholders and creditors against such violations of management's trust, if they are appealed to. The appeal is seldom made. It is not always easy to detect water in stocks; it is even more difficult to trace its source.

The problem of watered stock in American corporations is not new. Indeed with the common use of no-par stock in recent years, it may be less serious than it was earlier. In discussing watered stock and stock dividends from fictitious surpluses, Poor's *Manual* of 1869 (page xxxi) says:

Such enormous additions to the capital of companies without any increase of facilities extended to the public, or any increased capacity to earn, is the great danger to which our railroads are exposed, and which threaten more than anything else to destroy the value of railway property as well as to prove most oppressive to the public.

**English Terminology.**—The English describe what we call common stock by the title "ordinary shares." The two terms have almost an identical meaning. The English make fairly common use of a sort of subcommon stock seldom used in this country. They call it "deferred" or "deferred

ordinary" stock. Such stock is inferior to the ordinary shares. Where it is used, it really elevates ordinary stock to the preferred class.

These deferred shares are usually issued to corporate organizers and give them a final claim on the earnings, after all who have contributed capital to the corporation have been paid their contractual interest or dividends. Other terms used to describe such shares are "founders' shares" or "management shares." Where any of these types of shares are used, only a relatively small number are issued for any one corporation. Frequently they are endowed with exclusive voting power, except during such periods when contractual dividends on other types of shares may be in default. Meantime, the proportion of earnings to which such shares is entitled is likely to be quite large. The 100 founders' shares of the Imperial Colonial Finance and Agency Corp., Ltd., are entitled to one-half the company's profits after paying 7 per cent noncumulative dividends on its 270,275 ordinary shares, par £1. The 100 management shares of Wm. Whitelay, Ltd., are entitled to  $7\frac{1}{2}$  per cent of the dividends distributed in any year after payment of dividends on the company's preference stock and provision for a reserve fund of £10,000. The 1,000 management shares of Maple and Co., Ltd., are entitled to three-tenths of the annual earnings after provision for dividends on £2,000,000 preference stock. In addition, the company has £1,800,000 ordinary stock.

In rare instances, such stock has been issued by American corporations. The founders' common stock of Jenkins Bros. has exclusive voting power. In all other respects it is identical with common shares. The founders' stock of the New York Shipbuilding Corp. has exclusive voting rights under ordinary conditions and is entitled (after preferred-stock requirements) to 35 per cent of net earnings distributed after 1928 and to 35 per cent of remaining assets in dissolution. The Anglo American Mining Corp., Ltd., incorporated in Delaware in 1933, has outstanding 25 no-par founders' shares. These 25 shares are entitled to 15 per cent of all dividends declared and of all proceeds from the sale of assets in case of dissolution. They are entitled to as many votes as there are common shares outstanding. Each common share has one vote. Founders' shares of Continental Shares, Inc., have no voting rights and are not entitled to dividends unless common stock is paid in excess of \$1 per share; in which case, founders' shares are entitled to one-fourth of all declarations in excess of \$1 per share on the common stock; provided further that the \$1 has been paid not only for the current year but for all previous years. In 1937, common shares numbered 2,517,336 and founders' shares, 10,000. Usually the promoters and bankers here are given blocks of the same common stock held by others.

**Unusual Names.**—To describe unusual circumstances, stocks are sometimes given unusual names. In addition to its common stock, the Baltimore and Ohio R.R. Co. has outstanding \$1,650,000 of "separate stock" issued in

1832 for the construction of its Washington branch. In 1928, the Pacific Tin Corp. was organized to acquire the assets of the Yukon-Alaska Trust. "Special" stock of the corporation was distributed, share for share, in exchange for the Trust certificates. This special stock has been gradually liquidated. When the liquidation process is completed, the stockholders will receive, share for share, common stock of the corporation. The "participating" stock of the New York Shipbuilding Corp. is entitled as a class (after preferred-stock requirements) to all net earnings from 1925 to 1928, whether or not declared in dividends, and to 65 per cent of all such earnings after 1928. In liquidation, it is entitled (after preferred-stock requirements) to all undistributed net earnings derived from operations during the period from 1925 to 1928 and to 65 per cent of all remaining assets.

**Subshares.**—In order that stocks selling at a high price may reach a wider market, they have sometimes been divided into subshares which carry a variety of names. The procedure of issuance of such subshares is to have any owner of common stock deposit it with a trustee and to issue against it the desired number of subshares. By this means, the price of the subshares is reduced correspondingly and a wider market is tapped. Since any owner of stock of a well-known corporation may dispose of his holdings in any manner acceptable to himself and the purchaser, the use of subshares invites the sale of stock by unscrupulous holders at exorbitant prices. For example, the deposit of 100 shares of stock of a well and favorably known corporation might be followed by the sale of 1,000 subshares. Let us assume that the full shares of stock were worth \$100 each. That would not prevent the sale of 1,000 subshares at \$20 each if gullible buyers can be found. If the full shares are quoted on a stock exchange and if they have an active market, such operations might be difficult unless purchasers were sought among those who never read the financial pages. But where a stock is inactive, or where it is not listed, it is easier for a profit-minded promoter to take advantage of unwary speculators who are not acquainted with stock-market terminology.

With the more recent wide use of no-par or low-par stock, there is less need than formerly for the resort to subshares. A few illustrations of earlier practices are as follows: In 1919, 300,000 "bankers'" shares of Cities Service Co. were issued against a deposit of 30,000 of the company's \$100-par common stock. With the reduction of the par to \$20 per share in 1925, bankers' shares became convertible into common stock at the ratio of 2 to 1. The ordinary shares of the Royal Dutch Co., par 1,000 florins, are divided into subshares of 100 florins. "American shares" were first issued, three for one, against Dutch subshares deposited in this country, and "New York shares" were issued, three for one, against Dutch subshares held on deposit in Holland. Subsequently, all American shares were exchanged for New York shares. Each 40 American shares of the Amsterdam Trading Co. represent

one share of the company's stock, 500 florins par value, and are exchangeable at that rate.

**Distinctive Features of Stock.**—Mention has been made of classification of stocks on the basis of qualitative differences. The three qualities most commonly differentiated are risk, income, and control. In those rare instances when corporations without debt have only one class of stock outstanding, control would rest with the owners of such stock, and they alone would have claim to the income and would share the risks involved in the enterprise. In most instances, the financial plan would not be so simple. The presence of either creditors or other equity holders changes the status of common stockholders with respect to these three qualities.

**Risk.**—Common stockholders are supposed to be the shock absorbers in case of corporate failure or financial embarrassment. Their equity is supposed to be absorbed first in case of losses. These suppositions are subject to several qualifications.

1. In many instances, the common stockholders originally make little or no contribution to the capital of the corporation. They may contribute services or a patent right, or they may be the recipients of blocks of stock because they promote the corporation or aid in securing capital contributions from other sources. If their risk is measured by their contributions, it may be small indeed.

2. Preferred stockholders may be the real shock absorbers. While the corporation is attempting to establish itself in the business world, it may use its profits to build up reserves and a large surplus, meantime denying profit distribution to preferred stockholders. These reserves and this surplus may then be used to absorb the shocks of lean years.

3. When the crisis of insolvency or financial embarrassment occurs, it does not follow that the common stockholders are the sole claimants to suffer losses or even the first ones to bear the brunt of the corporation's failure. As will be shown in Part VI, preferred stockholders and even bondholders and other creditors are asked to share the burdens of readjustment.

It is recognized that purchasers of common stock for value, either at the time of the organization of the corporation or later, do suffer losses in market value of their holdings in case of corporate failure, usually in larger proportion than the holders of any other type of corporate security.

**Income.**—Common stockholders must wait for income upon their investment until all contractual obligations of the corporation have been met. These include fixed charges on bonds and cumulative dividends on preferred stocks.<sup>1</sup> However, contingent interest and dividend charges can be so

<sup>1</sup> The common stock of the American Hair and Felt Co. is entitled to no dividends until the net equity of the first preferred is \$100 per share and that of the second preferred is \$75. Thereafter no dividends may be declared on the common in excess of the increase in the net equity of the second preferred until the latter shall equal \$100 per share, plus accrued dividends.

manipulated as to give the common stockholders an advantage. If preferred stock is not cumulative, no dividends may be paid upon it by the directors until the corporation can afford to pay dividends to both preferred and common stockholders.

In a study of 699 corporations for the years 1927 to 1929, Paton found that 256 paid no dividends on common stock during the 3 years; 65 paid in 1 year only; 100 in 2 years only; and only 278 in all 3 years. Most of the corporations studied had earnings available for distribution. In the aggregate, only 57 per cent of the earnings available for distribution was paid to the common stockholders. In general, corporations having preferred stock outstanding paid lower rates on common stock than did those without preferred stock.<sup>1</sup>

After contractual interest and dividends have been met, the common stockholders are entitled to all subsequent distributions of profits or accumulated earnings. As a consequence, when a corporation is unusually successful, while preferred stockholders and bondholders are limited to their stipulated incomes, common stockholders may be paid handsome incomes out of all proportion to their capital contributions.

Common stockholders alone usually share in so-called "melon cuttings" since, in the absence of participating clauses in preferred-stock or bond contracts, all surplus accumulations are presumed to accrue to the benefit of common stockholders.

**Control.**—Bonds seldom carry voting rights. Preferred stock may have the right though this is usually denied the holders thereof. Common stock frequently has exclusive voting privileges. Indeed, the tendency in the decade of the 1920's had been to limit the voting right still further to only a part of the common stock. For example, when Dodge Brothers, Inc., was organized in 1925, one-fifth of the common stock, all held by the banking and underwriting group, was given the sole right to vote and thereby to control the \$160,000,000 invested in other securities of the corporation by outside capitalists. The common stock of the Pacific Public Service Co. in the hands of the public is nonvoting. The voting common is all held by affiliated companies. The Hercules Powder Co. issued nonvoting common stock convertible into voting common stock while owned by specifically named individuals and corporations. Boards of directors usually represent voting common stock. Their bias, therefore, is in the direction of protecting the interests they represent.

**Kinds of Voting.**—In controlling the affairs of American business corporations, there are various methods employed to give shareholders the right to express their wills. In general, it is expected that each share of stock is entitled to one vote. While this is current practice, the old common-law theory gave each stockholder only one vote, regardless of the number of

<sup>1</sup> Paton, W. A., "Corporate Profits" (New York, 1935), p. 6.



his shares. In some cases common stock has only fractional voting rights. This occurs particularly where stock has been split into a larger number of shares. In order to maintain the balance of power between the common and preferred stock, the former may be given the right to vote only a fraction of a vote for each share. Another method of meeting the same situation is to give the preferred stockholders multiple voting rights—several votes per share. Sometimes preferred and common stock are voted separately. This is known as “class” voting. It is used where it is desired to get the independent expressions of common and preferred stockholders.

The division of common stock into two classes, for the purpose of concentrating control in the hands of the management group, invited a great deal of opposition because of the possibilities for abuses. This was one of the chief points of attack made by Prof. W. Z. Ripley in his provocative book entitled “Main Street and Wall Street,” published in 1927. Partly as the result of this publication, both the New York Stock Exchange and the New York Curb now refuse to list additional nonvoting common stocks. In administering the Public Utilities Holding Company Act of 1935, the Securities and Exchange Commission is authorized to require that all stock issues used shall have ratable voting rights. While the implication is that this regulation shall apply to new stock issues, presumably the commission might bring pressure to produce changes in existing stock. Recent changes in the Bankruptcy Act, to provide for reorganization of corporations, contemplate the prohibition of the use of nonvoting stocks in reorganized corporations.

The Railway Express Agency, Inc., is very unusual in that all its stock is owned by the participating railroads. It has outstanding 1,000 shares of no-par stock, subscribed for by these railroads at \$100 a share. This stock merely represents voting rights and does not affect the distribution of earnings. The British government owns one £20 share of the Cunard Steamship, Ltd., giving it the right to cast one vote for each pound of stock. However, this government share carries certain additional voting rights to be used to maintain the all-British character of the company.

**Proxies.**—At common law, a stockholder must be present at a meeting or be denied representation. Most state statutes provide, however, that absent stockholders may send proxies; *i.e.*, they may give their right to vote at a particular meeting to a representative. By-law provisions may supplement, or substitute for, statutes in this respect. Proxies are commonly used in American corporation procedure and are indispensable in the meetings of the large corporations with thousands of stockholders. Proxy forms are sent out to all stockholders who possess voting rights, asking that the individuals designated on such forms be appointed proxies for the stockholders solicited. Since the only action required of the stockholder is his signature on the printed form and the mailing of the document in the enclosed stamped and

addressed envelope, he is usually willing to make that amount of sacrifice to the welfare of his corporation. By this means, boards of directors virtually become self-perpetuating and, in effect, minorities, rather than majorities, control American corporations. By this means also, other minorities can be denied representation on boards of directors, since the insiders almost always control enough proxies to elect their entire slate. No shareholder of the Royal Dutch Co. is permitted to vote, either for himself in person or as a proxy, more than six votes.

**Proxy Contests.**—Occasionally a discontented minority is able to interest a sufficient number of other shareholders to present an effective argument to those in control. In such cases, two or more groups contend for the right to represent shareholders by putting up a fight for their proxies. Such contests ordinarily promise most chances for success of groups outside the management when well- and favorably known names are on the protesting committee. A few years ago, the Rockefeller group succeeded in wresting control of the Standard Oil Co. of Indiana from the insiders through a wide and well-publicized appeal for proxies. More recently, Frank A. Vanderlip and a group of associates, owning only a few hundred shares of stock of the Reo Motor Car Co., challenged the management, which owned over 15,000 shares of stock out of the 1,800,000 shares outstanding, by making an appeal for proxies. The appeal was sufficiently successful to win for the protesting group representation on the board of directors. The board was increased from five to nine, and the two groups joined forces instead of continuing their differences.

**Control over Proxy Solicitations.**—The Securities and Exchange Commission has complete authority to make rules and regulations governing the solicitation of proxies through the use of the mails or an organized securities exchange. Acting under this authority, the commission has formulated rules that define "solicitation" and specify its use. Included in these rules are the types of information that must be supplied to the stockholder at the time his proxy is requested. The authority of the commission covers not only proxies, but also consents and authorizations of any kind that a stockholder may be requested to sign. The same law prohibits any dealer in stock or any broker to give proxies for voting stock which he may have in his accounts.

**Use of Proxies.**—The actual use of proxies is illustrated in an unpublished study made by Herman H. Beneke in 1939.<sup>1</sup> In response to a questionnaire sent to small, medium, and large corporations, he found that the percentage of votes cast at both regular and special stockholders' meetings ranged from 47 to 84 per cent of the number eligible to vote, with the average 65 per cent. Except for two corporations in which no proxies were used, 91 per cent of

<sup>1</sup> Beneke, Herman H., *The Voting Right of Corporate Stocks*, submitted in partial fulfillment of the requirements for the Ph.D. degree at Ohio State University, 1940.

the votes cast were by proxy. The lowest percentage of proxy vote was 70, and a majority of the corporations responding to the questionnaire indicated that proxy voting accounted for more than 99 per cent of all votes cast.

As is to be expected, many holders of only a small amount of stock disregard proxy requests. Not knowing too much about the subject, they are inclined to make no response when they are asked to sign and return proxies. For example, at the annual meeting of the General Motors Corp., held in May, 1946, only 36 per cent of the stockholders returned the proxies that were sent out by the corporation. However, these proxies represented 69 per cent of all outstanding common stock. Incidentally, according to a communication from the corporation to its stockholders, "This representation was the largest for any annual meeting in many years."

**Quorum.**—In the absence of proxy votes, it might be impossible for some corporations to hold legal meetings of stockholders because of the absence of a quorum. At common law, those present at a regular or a called meeting constitute a quorum. Some statutes merely reaffirm common-law practices. Others presume that each corporation will provide in its by-laws the amount of stock needed to be represented at a meeting to make it legal. As indicated above, in the earliest corporations each shareholder had one vote. The modern practice is to give each shareholder the right to vote as many votes as he has shares of stock. In fixing the necessary number for a quorum, it is customary to take into account the probable number of shares that will likely be represented at a meeting, proxies included. On most questions, when a quorum is present, a majority of those voting on any particular issue would be sufficient to decide it. On some questions, vitally affecting the life of the corporation, a much larger vote may be required.

**Cumulative Voting.**—An organized minority of sizable proportions frequently has at hand an adequate weapon of defense against such majority control. A common provision in corporate charters and even in some statutes is the right of cumulative voting. A simple illustration will show the meaning of this term. Suppose there are five directors to be elected. Ordinarily, each share of voting stock carries the right to cast one vote for each of five directors. But where cumulative voting is permitted, all five of these votes may be cast for the same individual, or the votes may be concentrated on less than five candidates. By this means, a minority of 17 per cent of the total stock, concentrated upon one candidate, could elect him regardless of the distribution of the votes of the other 83 per cent of the stock voted; a minority of 29 per cent could be sure of electing two of the five candidates by cumulating their votes; while a minority of 38 per cent, by concentrating upon three candidates, could fill three of the five vacancies, if the majority attempted to fill all five by failing to cumulate their votes.

It is understood of course that cumulative voting is confined to the election of directors. It would not apply to any issue where a "yes" or "no"

vote is called for. In order that there may be cumulative voting, there must be the opportunity for multiple votes by each stockholder on a single issue. The election of more than one candidate for the same or a similar office provides the single opportunity of this character. Even here there is great opportunity for minority representation, at least if stockholders saw fit to take advantage of it.

Illinois permitted cumulative voting at elections of corporate directors as early as 1870, Pennsylvania in 1874, and California in 1879. Most of the states have given the shareholders the right to cumulate their votes or have provided that their corporations may grant such right.<sup>1</sup> Corporations whose stocks are entitled to cumulative voting in the election of directors include Sears, Roebuck and Co.; National Fireproofing Corp.; Fairbanks, Morse and Co., both preferred and common stock; and American Colortype Co., both preferred and common.

**Place of the Common Stockholder.**—The position of the common stockholder in American business corporations depends upon his rank among the claimants to earnings and assets. Except in close corporations, few “outside” common stockholders undertake to exercise much voice in the management. The insiders use their positions as officers and directors to dominate the control of the corporation. Outsiders are passive recipients of whatever favors come their way.

If the common stockholders actually “own the business,” with no bondholders or other creditors ahead of them, the position of the stockholder is subject merely to the hazards of the business in which he is a participant. But if he occupies the residual position described at the beginning of this chapter, where he is the last of perhaps a long line of claimants to the income and the assets of his corporation, he is not the real owner. He is just the so-called “equity claimant”—where the term “equity” frequently means that there is little or no equity. If the stockholder knows the risks that he assumes in any given situation and feels that the chance for gain outweighs the risks, he is justified in buying the stock if he can afford to take the risk. But in the presence of the complex financial plans of some American corporations, it is doubtful if even an expert can measure the risk assumed. Henry Ford knows who owns the Ford Motor Co. It is doubtful if anybody knows who owned the Associated Gas and Electric Co. at the time it had outstanding 28 separate and distinct issues of bonds and other interest-bearing obligations, 11 separate issues of cumulative preferred stock, and 2 separate issues of classified common stock—all with claims prior to more than a million shares of common stock. Even this statement takes into account only funded debt and stock and ignores unfunded debts and outstanding rights of one kind and another.

<sup>1</sup> Bowes, H. E., and L. A. De Bow, Cumulative Voting at Elections of Directors of Corporations, *Minnesota Law Review*, March, 1937, pp. 351-352.

The issuance of new common stocks is a function of fair-weather economics. In a boom year like 1929, more than twice as much new common stock was fed into the market as was absorbed in the succeeding period of 9 years, 1930 to 1938. Meantime values, or at least quoted prices, dissolved into thin air as soon as the bubble was pricked. Prices of common stocks of leading corporations in our basic industries tumbled from fantastic heights in 1929 to almost the vanishing point in 1932. When the leading producers of steel, electrical equipment, chemicals, copper, and other similar products witnessed a drop in the prices of their stocks of an average of more than three-fourths from 1929 to 1932, one wonders who were the buyers of stocks at the high prices of 1929 and who were the sellers at the bottom of the market in 1932. Incidentally, this kind of situation raises some interesting questions about any proposed solution of corporate problems which assumes the competence of stockholders to manage their own affairs.

**Common-stock Theory of Investment.**—It has long been contended that, in periods of rising prices, common stocks stand a much better chance of price appreciation than do other types of securities. To provide a statistical test of this principle, Edgar L. Smith investigated the question and published his findings in 1924. This publication started a long series of discussions on the subject of the "common-stock" theory of investment. Smith's own statement of the "law" that he discovered reads as follows:

Over a period of years the principal value of a well diversified holding of common stocks of representative corporations in essential industries tends to increase in accordance with the operation of compound interest.

Such stock holdings may be relied upon over a term of years to pay an average income return on such increasing values of something more than the average current rate on commercial paper.<sup>1</sup>

The discussion following the publication of this theory has run the gamut from attempts to disprove it to other attempts to push it even further than Smith intended. Much of the discussion has ignored the limitations and qualifications imposed by the author of the theory. Some have jumped to the conclusion that stocks are always safer investments than bonds; that they not only advance more rapidly during periods of prosperity, but that they decline less in periods of depression. The author of the "common-stock" theory warned his readers that he merely found that (1) over a period of years, (2) a well-diversified holding of common stocks, (3) of representative corporations, (4) in essential industries, (5) tends to increase in value in accordance with the operation of compound interest. Each and every one of these limitations is significant. Disregard for any one of them may easily invalidate the theory.

<sup>1</sup>Smith, Edgar L., "Common Stocks as Long Term Investments" (New York, 1924), p. 79.

Certainly no one can, with impunity, buy any stock at any time and sell it without regard for price levels at the time of sale and expect to make a profit. To be sure there are always great profit possibilities during times of rapidly rising stock prices. Myriads of speculators, without any knowledge of finance or stock-market operations, bought stocks on the rising market of the 1920's and soon complimented themselves on their good judgment when the prices of their stocks recorded substantial increases. Those who failed to sell before the bubble burst suffered great losses, in spite of the temporary paper profits that the stock ticker recorded for them. Smith's theory contemplated neither the boom prices of 1929 nor the depressed prices of 1932. It is concerned with long-term trends in values, irrespective of intervening prices.

Even with the limitations imposed in the statement of the common-stock theory, it is doubtful if its conclusions would hold true against a selection of stocks at the height of our greatest booms. For example, suppose the selection had been made at the peak of the 1929 boom. Is it likely that the other limitations of the theory would protect it against subsequent experiences of business profits and security prices? Certainly at no time in the period since 1929 could it be shown that values have increased "in accordance with the operation of compound interest." Nor is it necessary to make the selection at the bottom of a depression in order to prove the theory true, provided that its limitations are observed.

On the average, common stocks tend to earn more than is paid in the form of dividends. The remainder is retained by the corporation either as a part of surplus or is capitalized in some form. In either event, the common stockholder benefits from the reinvestment of undistributed earnings. But as we approach the prosperity peak, prices of stocks reflect neither dividends received nor even current earnings. Instead stock prices reflect the hope of earnings which the corporation may never realize. Hence prosperity stock prices make no allowance for the reinvestment of realized surplus earnings, without which the common-stock theory would have no foundation in fact. Likewise, depression prices frequently ignore the plowing back of earnings which helps to make the long-run position of the stockholder more secure even though, for the time being, he should receive no dividends.

The net conclusion is that, for the average purchaser of stocks, about the only help he can obtain from the common-stock theory is the advice to observe its limitations. By doing so the average stock purchaser will avoid the consequences of special hazards—and opportunities—that help to condition movements in the prices of special stocks but over which he cannot hope to have any control. Ordinarily, he cannot even know of their existence or of their probable effects. But on the very important question of timing—either the time to buy stocks or to sell them—the common-stock theory has nothing to offer. The man who bought stocks in 1932, when he

thought they had dropped to a "new low" level, found by 1933 that instead he had bought when prices were at an "old high" level. While the prices he paid in 1932 were relatively much lower than the corresponding prices for 1929, they were also relatively higher than they were at a later date. Unless he held his purchases "over a period of years," he probably suffered a loss.

One implication of the common-stock theory of investments is intriguing. Suppose all stock purchasers observed all the limitations of the theory, and suppose further that they all concluded to buy the stocks of the same corporations. What would be the consequences, measured in terms of the prices of these stocks and of those no longer in demand?

### QUESTIONS AND SUGGESTIONS

1. What is the difference between stock and shares in England? In America?
2. Explain what is meant by the residual position of the common stockholder.
3. Define the relationship of authorized, issued, and outstanding stock.
4. What is treasury stock, and why is it acquired? What are the arguments for and against its acquisition?
5. Explain stock tenders, and state why they are used? If the stock is listed on an exchange, why not buy it in the open market instead of on tenders?
6. What are the arguments against a corporation speculating in its own stock?
7. What is the significance of the table comparing stock values of the Erie, Allied Chemical and Dye, and J. I. Case?
8. What is watered stock? What are the possible sources of the water?
9. What is deferred stock, and why is it used? What term has sometimes been used in America to describe this kind of stock?
10. What are subshares, and why are they used? How has the common use of no-par stock affected the use of subshares?
11. In analyzing common stock, what distinctive features are studied? Which is of greatest importance?
12. What are the possible kinds of voting rights for common stock? What are current tendencies on this subject?
13. Sample "Main Street and Wall Street" by W. Z. Ripley, and state your impressions of this book.
14. What is a proxy, and why is it used? Who may give a proxy, and who may exercise the rights under it?
15. Why do proxy contests sometimes develop? Who generally has the advantage in such contests? Why?
16. How do the rules of the Securities and Exchange Commission affect proxy contests?
17. Illustrate the use of cumulative voting. On what subjects is it useful?
18. Explain and account for the place occupied by most common stockholders in determining the policies of their corporations.
19. State the common-stock theory of investment. Of what use is it to the average investor? Of what use is it to corporate managements?
20. What erroneous implications are sometimes attached to this theory?
21. Name several stocks that you consider sound investments. Several that you consider highly speculative. Justify your conclusions in each case.

## SUPPLEMENTARY READINGS

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## SUBJECTS FOR INVESTIGATION

1. Secure access to a common stock certificate, and summarize its contents.
2. Draw up a proxy statement, giving you the right to represent me at the forthcoming meeting of the stockholders of the XYZ Corporation. You may use as a model any proxy to which you have access.
3. Make a list of five corporations that have only common stock outstanding—no bonds and no preferred stock.



## CHAPTER VII

### STOCKS WITH PREFERENCES AND LIMITATIONS

**Definition.**—The term “preferred” stock in American finance, or “preference” stock in English practice, is often misleading to the layman and is erroneously used even by those who should know better, for these terms are too narrow to describe the actual conditions surrounding these securities. A trite definition of preferred stock and yet one that will bear analysis is as follows: “Preferred stock is exactly like common stock except for modifications imposed by law or by contract.” This definition implies two things: (1) Differences must be established by positive action. Otherwise they do not exist. (2) These differences may be either preferences or limitations, additions or subtractions. In practice, both are usually present at the same time and condition each other.

**Origin.**—Preferred stock owes its origin to the capitalistic nature of English canals and railways. Optimistic promoters with insufficient capital started projects that could be completed only by offering bait to timid investors whose contributions were needed. Incidentally, preferred stock of modern corporations has the same origin. As an alternative to preference stock, discount sales were authorized. The Companies Clauses Consolidation Act of 1845 authorized the sale of shares “of such amount,” “in such manner and on such terms” as the company saw fit to employ.

Interesting names were applied to some of the preference shares first used, such as “active,” “county,” “profitable.” Ordinary shares were commonly called “passive,” “adventurers,” and “patriotic” shares. As early as 1848, letters of the alphabet and numbers were used to designate the classes of shares. Some of the early preference shares were limited to reducible dividends—high rates for a specified number of years with reduced dividends thereafter. In some cases, the preference as to dividends was effective only until the ordinary shares could earn the same dividend, until the railway was open for traffic, or for a fixed period of, say, 10 years. In other cases, preferential dividends were granted in perpetuity.

Before 1839, preference stock sometimes had preference over creditors’ claims. Dividends on preference stock were first used in 1826. It was not until 1857 that a court decision made them cumulative, in the absence of a provision to the contrary.<sup>1</sup>

<sup>1</sup> Evans, G. H., Jr., “British Corporation Finance 1775–1850” (Baltimore, 1936), *passim*.

## I. PREFERENCES

**Meaning of Preference.**—The terms “preferred” or “preference” must not be construed to carry or even to imply a guarantee of any kind. Furthermore, there is a tendency to think of preferred stock as a kind of security that always possesses the same attributes. Preferred stock has already been defined as stock that is exactly like common stock, except for modifications that are imposed by law or by contract. It naturally follows that these modifications may be slight or serious, single or multiple, and that an infinite series of combinations may result. It is well therefore to start with the idea that there must be some difference or differences between the preferred and the common stock of any specific corporation; but that the exact nature of the differences can be determined only by a careful analysis of the contract establishing the preferred stock. All preferences should be stated on the stock certificate. In some states this is required by statute. In other states it may be necessary to inspect the statutes, the charter, and the by-laws as well to determine the exact nature of the preferences possessed by the preferred stock.

All preferences are relative. A 5 per cent preferred stock is not necessarily one that pays 5 per cent in dividends. It is one that is entitled to 5 per cent before the common stock is entitled to any distribution. It may, in any given year, pay 5 or 3 or 2 per cent—or nothing at all. In any case, it has a preference up to 5 per cent before the common receives anything. Preferences are merely relative advantages over common stock. They are not, in any sense, guarantees. The usual preferences possessed by preferred stock, in varying combinations, determined by the law and the preferred-stock contract, may be classified under five headings: income, assets, control, convertibility, and safeguards. Without subtracting from the caution stated above in terms of the necessity for studying each particular case, it is possible to define the broad patterns within which most preferences are cast. The following analysis deals with the five headings under which most preferences can be grouped.

**1. Income.**—Perhaps the most common preference gives the holder of preferred stock greater security than the common stockholder with respect to income. Most preferred stock carries this preference. Until quite recently, the usual rates of dividend preference for industrial preferred stock, which represented new capital contributions to the corporation at the time it was issued, were 6 to 8 per cent. Meantime, since most railroad preferred stocks contain an element of coercion, being the result of corporate reorganizations, rather than of original capital contributions, 4 per cent is the most common dividend rate carried by preferred stock of railroads. Because of the abundance of cheap money available beginning in the late 1930's, many industrial corporations refunded their high-dividend preferred stocks with similar issues that carry a considerably lower dividend rate.

Many now have a preference up to only 4 to 5 per cent. A considerable number are even less than 4 per cent.

The relative character of preferential dividend payments is shown by the results of a study made by Paton for the years 1927 to 1929. These are usually considered boom years in American industry, and therefore we have a right to expect liberal dividend payments to preferred stockholders. The Paton study covered 699 corporations. Even for these boom years, only 72 per cent of the larger corporations and 55 per cent of the smaller ones paid any dividends on their preferred stock. Such percentages should go far to dispel any conception of dividend preferences being anything more than they are intended to convey—a right to a distribution of earnings *before* anything is paid on common stock.<sup>1</sup>

*a. Cumulative.*—Preferred-stock dividends are either cumulative or non-cumulative. Cumulative means that dividends, which are not paid when anticipated, are expected to be paid at some future date before the holders of common stock are entitled to receive any payments. Boards of directors are not usually prevented from exercising their discretion in the payment of dividends. But if they do not meet cumulative-dividend requirements each year, they assume a continuing obligation to pay on the preferred stock the accumulated specified dividends for each year, before any dividends can be paid on the common stock. In practice, the chance of collecting, in cash, accumulated dividends is inversely proportional to the size of the accumulation. Occasional exceptions prove the rule. In the early part of 1937 the Magar Car Corp. declared a dividend of \$36.75 to clear up the accumulation on its 7 per cent preferred stock. It then proceeded to declare a dividend of \$1 on the common stock, the first distribution to that class of stock in more than 10 years. After being in arrears on its 7 per cent cumulative preferred stock, par \$100, since 1931, the Federal Mining and Smelting Co. paid \$10.50 in 1936 and the remaining arrears, amounting to \$29.75 per share, in 1937. In 1937, Consolidated Retail Stores, Inc., paid an accumulated dividend of \$28 to its preferred stockholders from the proceeds of the sale of new common stock to holders of outstanding common. The preference stock of De Beers Consolidated Mines, Ltd., is entitled to 40 per cent cumulative dividends. Full dividends were paid from 1919 to the middle of 1931. Thereafter no dividends were paid until 1936, when 160 per cent was paid on account of accumulations. Where the accumulation extends over several years, the boards of directors, dominated by common-stock interests, usually compromise with the preferred stockholders or fund the dividends in some manner as soon as the financial position of the corporation warrants consideration of the resumption of cash payments. With the accumulation of back dividends on preferred stock disposed of, cash dividends on common stock can be provided for.

<sup>1</sup> Paton, W. A., "Corporation Profits" (New York, 1935), p. 6.

Dividends on some preferred stocks accumulate surprisingly large arrears before any adjustments are attempted. Recent illustrations include:

Name of Company	Percentage of Dividends in Arrears
Hartman Tobacco Co. ....	First preferred 6½ per cent stock—47¾
Certainfeed Products Corp. ....	Preferred 7 per cent stock—57¾
Market Street Ry. Co. ....	{ Prior preference 6 per cent stock—90½
	{ Preferred 6 per cent stock—96½
Amalgamated Leather Co. ....	Preferred 7 per cent stock—105¼
Fairbanks Co. ....	First preferred 8 per cent stock—128
American Hide and Leather Co. ....	Preferred 7 per cent stock—217¾
Rutland R.R. Co. ....	Preferred 7 per cent stock—364

In each of the above cases, the accumulation stated is for 1937. Since that time, the accumulations cited have all been funded in some manner except those for the Market Street Ry. Co. which, at the end of 1945, had unpaid dividends on the prior preference stock amounting to \$142.50 per share and on the preferred stock of \$148.50; and the Rutland R.R. Co., whose unpaid dividends amounted to \$420 per share at the end of 1945.

**PLANS FOR FUNDING DIVIDENDS.**—So long as prospects for earnings of a corporation remain dark or colorless, there is not much incentive for boards of directors to rid themselves of accumulated dividends on preferred stock. If existing contingent obligations do not interfere with future dividend prospects because there are none, then there is no good reason to disturb existing arrangements. It is only when dividend-hungry common stockholders think they see bright spots in the earnings sky that plans are made for disposing of the hindrances to common dividend declarations. Then plans for funding accumulated preferred dividends blossom on every bush. A wide variety of such plans are utilized. Only a few are given here as illustrations. In nearly all of them, some form of funding of accumulated dividends is proposed.

In 1937, Kresge's Department Stores, Inc., offered the holders of outstanding 8 per cent cumulative preferred stock, \$100 par—with \$58 per share dividend arrears—one and one-half shares of new 4 per cent cumulative convertible first preferred stock, par \$100, and one-half common share. The Huston Oil Co. gave the preferred stockholders 6 per cent accrued-dividend certificates for unpaid dividends. In 1937, the Converse Rubber Co. issued \$0.60 special cumulative preferred stock in payment of arrears on its \$2 cumulative preferred stock. In funding an accumulation of \$24 per share on its 7 per cent cumulative participating preferred stock, Canadian Celanese, Ltd., issued in lieu thereof no-par noncumulative income funding rights, entitled to \$1 per year before payment of preferred dividends and redeemable at \$25 per right. In addition, the company obligates itself to build up a fund equivalent to 3 years' income payments on these rights before paying any dividends on common stock.

In exchange for dividend accumulations of \$35 per share on its 7 per cent preferred stock, the Bradley Knitting Co. declared a dividend of \$20 per share in non-interest-bearing convertible dividend warrants redeemable in 1946. The company offered, for a period of 30 days after their issuance, to buy these warrants at \$0.50 on the dollar in cash. In 1937, the Illinois Iowa Power Co. issued to its preferred stockholders dividend-arrears certificates due 1940 and payable in installments before any dividends may be paid on common stock, in exchange for \$24 per share accumulated dividends. At the same time, writing down of stated value of stocks wiped out a deficit and opened the way to the resumption of cash dividends. Accumulated dividends on the \$6.50 preferred stock of the Ludlum Steel Co. amounted to \$19.50 per share in 1933. The stockholders ratified a cancellation of this accumulation in return for a payment of \$1 per share and a new conversion privilege, entitling the preferred stockholders to convert each share into five shares of common stock. The McCord Radiator and Manufacturing Co. created funding stock and issued one share with each Class A share to eliminate \$19.50 dividend in arrears. It was redeemable at \$19.50 per share during 1936 and at \$1 premium for each full year thereafter. A sinking fund of 20 per cent of net earnings was provided for 1938 and thereafter. It was convertible into Class B stock on a share-for-share basis. Instead of offering to fund accumulated dividends on its preferred stock, the Consolidated Retail Stores Co. provided for writing down its common stock from \$5 par to \$1, thereby increasing the surplus account, and then offering new stock to the common stockholders at \$9 per share.

An interesting case of funding accumulated dividends occurred in the Certainteed Products Corp. As of 1944, there was an accumulation of \$42 per share on its 6 per cent preference stock. In July, 1944, the company offered to exchange 20 shares of common for each share of preference stock and its accumulated dividends. The price range of this common stock in 1944 was \$9 high and  $4\frac{5}{8}$  low. The price range in 1945 was  $16\frac{7}{8}$  and \$7. It had paid no dividend since 1929. A total of 18,732 preference shares were so exchanged. In November, 1944, the company offered to exchange 18 shares of common stock and \$5 cash for each preference share. A total of 16,571 preference shares were exchanged on this basis. In February, 1945, the offer was reduced to 17 shares of common and \$5 cash, and 15,357 shares were exchanged. In June, 1945, the company offered one \$100 par  $4\frac{1}{2}$  per cent prior preference stock, 5 shares of common, and \$4 cash for each preference share. A total of 12,134 6 per cent preference shares took advantage of this offer. In February, 1946, the offer was changed to one share of  $4\frac{1}{2}$  per cent prior preference stock and \$7.50 cash, with 2,877 shares of 6 per cent preference stock taking advantage of it. In June, 1946, the remaining 1,702 shares of 6 per cent preference stock were retired at \$110 per share, plus remaining unpaid dividends.

When the Struthers Wells Titusville Corp. had accumulated arrearages of \$36.75 on its \$100-par 7 per cent preferred stock, the arrearages were eliminated and the company's capital account revamped by securing the approval of a substantial majority of the stockholders to a plan that exchanged each share of existing preferred stock and arrearages for five shares of new \$1.25 cumulative preferred stock, with a liquidating value of \$25, and one share of common stock currently selling at about \$11 per share. The new preferred stock is convertible into common, share for share, for a period of 5 years. Taking a cue from the practice of issuing adjustment bonds in the case of reorganizations, the Dennison Manufacturing Co., in order to eliminate an accrual of \$38.50 per share on its 7 per cent \$100-par, cumulative preferred stock, issued 300,000 shares of no-par adjustment stock. Each share of preferred stock was to be exchanged for one share of \$7 no-par preferred, the dividends to be cumulative only if earned, and four shares of adjustment stock. Each share of Class A stock was entitled to be exchanged for one share of adjustment stock. Even income bonds have occasionally been used to fund accumulated dividends. In 1937, the Columbia River Paper Mills offered \$140 in 5 per cent income bonds, maturing in 30 years and callable on any interest date, in exchange for each \$100 of preferred stock.

**ALTERNATIVE PLANS.**—In the recapitalization that has as its objective the funding of accumulative dividends on preferred stock, various plans are utilized, including some that give alternative choices. The holders of the 7 per cent preferred stock of the Nashua Manufacturing Co., with dividends in arrears of \$45.50, were offered in exchange, share for share, \$5 cumulative convertible Class A preferred stock. In the funding of the accumulated dividends, the plan proposed a payment of \$3 in cash as soon as the earnings permit and the remainder before 1938, in cash or in \$5 non-cumulative convertible Class B preferred stock. Each share of Class A was to be convertible into one share of common stock and each share of Class B into one and one-fourth shares of common. Each was callable at \$105 per share.

**SIMPLE SOLUTION.**—When the Converse Rubber Co. had accumulated \$12 per share in unpaid dividends on its \$33-par preferred stock, the common stockholders requested that the dividends be funded and offered a very simple plan to accomplish the purpose: *viz.*, the issuance of \$45-par preferred stock and its exchange, share for share, for the \$33-par stock and the \$12-dividend accumulation. This plan has possibilities. With the consent of the preferred stockholders, it might be used every time preferred dividends accumulate. Meantime, with the preferred arrearages "taken care" of, there would be no obstacle to the declaration of dividends on the common stock.

**Attitude of Shareholders.**—The attitude of shareholders toward exchanging preferred shares and accumulated dividends for lower dividend securities

may also be said to be that of "yes men." Seldom do they refuse to accept plans proposed to them even though, on analysis, questions might be raised about their best interests. A few instances indicate the vote for recapitalization plans: Barker Brothers Corp. plan of eliminating preferred-dividend arrears was approved by holders of 92 per cent of the preferred stock and 81 per cent of the common; no votes were cast against it. Within 4 months after the Certainteed Products Corp. offered a plan of funding preferred-dividend arrears, all but 2,775 of 63,004 preferred shares had been exchanged. The Remington Arms Co., Inc., exchanged 96.6 per cent of their preferred stock within 2 months. The Goodyear Tire and Rubber Co. plan was accepted by holders of over 98 per cent of the preferred stock. The Oxford Paper Co. plan was approved by 93 per cent of preferred stockholders. The plan of Ayre Associates, Inc., was approved by the holders of 93 per cent of preferred stock and 96 per cent of common.

Occasionally, the corporation is not so fortunate in enlisting the support of shareholders. The Otis Steel Co. was forced to extend the time of accepting its plan. After several extensions, covering a period of 3 years, Armour and Co. (Illinois) was able to induce holders of only \$4,000,000 out of \$57,000,000 of its 7 per cent cumulative preferred stock to accept exchanges for their stock.

**Nonassenting Preferred Stockholders.**—Not all nonassenting preferred stockholders are opposed to dividend-funding plans. Some hesitate to present their stock for conversion because they have no basis for judgment about the proposed new financial plan. Others—usually a small minority—actively dissent from the program. The corporation may deal with non-assenters in five ways: (1) The most common is to redeem their stock at the call price. This can be done if the amount involved is small. (2) Their stock may be purchased in the open market or by agreement at less than the call price. (3) No change may be made in their status. When the holders of three classes of preferred stock of the Pure Oil Co. were offered a plan of funding their accumulated dividends, those who did not accept the plan were paid their full dividend accumulations in each. (4) On occasion, the nonassenting holders may even be placed in a preferential position over the assenters. Preferred stock of Marshall Field and Co. not exchanged in a recent plan for funding accumulated dividends was thereafter designated prior preference stock, taking precedence over the new preferred. (5) Active dissenters may force special treatment for themselves or even abandonment of the proposed plan. The objecting preferred stockholders of the Godchaux Sugars, Inc., appealed to the Supreme Court of New York and received an order for payment of \$10 cash to liquidate \$39.08 dividends in arrears and a 60-day 6 per cent note to redeem the stock at \$95 per share. Objections of a minority of preferred stockholders

of the International Silver Co., supported by an injunction, caused the abandonment of a plan to fund accumulated dividends.

**Use of Prior Preference Stock.**—As an inducement to fund dividends on preferred stock, new stock offered in exchange is sometimes given the status of prior preferred, with priority over stock not so exchanged. In funding \$35 accumulated dividends on its 7 per cent Class A cumulative preferred stock, the Washington Pump and Machinery Corp. offered in exchange for each share of this stock and accumulated dividends one-half share 4½ per cent convertible prior preferred stock, one-half share 4½ per cent nonconvertible prior preferred stock, and one and one-fifth shares of common stock. To the holders of its 6 per cent Class B cumulative preferred stock, with \$30 in arrears, the company offered one-half share of convertible prior preferred stock, one-half share of nonconvertible, and three-fourths share of common stock. It was made clear that those who did not wish to make the exchange could retain their old stock. Remington-Rand, Inc., submitted a similar plan to its preferred stockholders.

**Use of Convertibles.**—In the funding of cumulative dividends on preferred stock, it is common to make the new preferred stock convertible. Occasionally, early advantage is taken of the conversion privilege with the result that old preferred stock and accumulated dividends become new common stock. Within 8 months after eliminating \$57.75 dividend arrears on its preferred stock, the Kellogg Switchboard and Supply Co. had converted one-third of its new preferred stock into common.

**Peculiar Funding Plans.**—Limitations of space will not permit a presentation of the multiplicity of dividend funding plans offered. A few only can be added to the general programs described above. The Heywood Wakefield Co. exchanged for each share of 7 per cent preferred stock, par \$100, and accumulated dividends of \$47.25, \$100 principal amount of new debenture 5s, one share of 5 per cent first preferred stock, par \$25, and \$22.25 in cash.

The Durham Hosiery Mills, Inc., offered to (1) purchase from the holders of 6 per cent cumulative preferred stock one-third of their holdings at \$30 per share; (2) issue Class A 6 per cent cumulative preferred stock for the other two-thirds; (3) exchange two shares of Class B common stock for \$38.50 accumulated dividends; (4) leave undisturbed 12,500 shares of Class A and 37,500 of Class B common stock.

The preferred stockholders of the Penn Anthracite Collieries Co. received in full payment of dividend arrears 25 per cent of the amount accumulated, applying the same to the purchase of common stock at \$25 per share. This was equivalent to accepting one-half share of common stock in exchange for accumulated dividends.

**Treatment of Common Stockholders.**—When preferred stock and accumulated dividends are exchanged for other securities, common stock-



holders sometimes are asked to accept different securities too. The following summary shows what happened in several recent cases:

Name of Company	Change in Common Holdings
Abercrombie and Fitch Co. ....	New for old
Amalgamated Leather Co. ....	$\frac{2}{3}$ new share for 1 old
American Hide and Leather Co. ....	No-par to \$1 par
Ayre Associates, Inc. ....	3 new \$1 for 1 old no-par
International Silver Co. ....	\$100 to \$50 par
Libby, McNeill and Libby ....	\$10 par for no-par, stated value \$7
Mangel Stores Corp. ....	To \$1 stated value
Skenandoa Rayon Corp. ....	No-par for \$5 par
Stover Mfg. and Engine Co. ....	\$15 par changed to no-par
Van Camp Milk Co. ....	6 new for 1 old

In most instances, the common stock is not disturbed other than by the issuance of additional shares to preferred stockholders. Since one of the major purposes of the funding of accumulated dividends on preferred stock is the clearing of the decks for dividends on common stock, the holders of the latter are expected to benefit from the funding process.

When the U.S. Holding Co. had accumulated more than 100 per cent dividend arrears on its 7 per cent cumulative preferred stock, which, incidentally, is entitled to par and accumulated dividends in case of involuntary dissolution and to 110 and accumulated dividends if voluntary, the common stockholders' committee proposed a reorganization, preliminary to dissolution, which would result in placing the common and preferred stock in the same class. The preferred stockholders appointed a committee to discuss the question with the common stockholders' committee.

**LIMITATIONS.**—Many so-called cumulative preferred stocks are limited by special provisions like the following. The first preferred stock of the Baltimore Transit Co. is cumulative to this extent: If any installments are not paid and thereafter there is surplus income after payment of current preferred dividends, 55 per cent of such surplus income distributed shall go to the preferred stockholders until such arrears have been paid. The \$0.50 cumulative preferred stock of Cheney Brothers is entitled to dividends up to \$0.50 per share per annum, cumulative for the years 1937, 1938, and 1939, only to the extent earned; thereafter, such dividends are cumulative whether or not earned. The \$6 preferred stock of the New England Laundries, Inc., is noncumulative to 1938. It is cumulative to the extent of \$4 per share for 1938; \$5 for 1939; and thereafter at \$6. The cumulative Class A preferred stock of the Gruen Watch Co., par \$100, is entitled to cumulative dividends of 1 per cent for 1936, 2 per cent for 1937, 3 per cent for 1938, 4 per cent for 1939, and 5 per cent thereafter. The 5 per cent cumulative preferred stock of the Swiss-American Electric Co. (a Swiss corporation) is entitled to 5 per cent cumulative dividends, with a limit of 15 per cent. Claims for arrears for every year prior to the last 3 years

are automatically canceled. The preference stock of the Alabama Great Southern R.R. Co. is entitled to a dividend of 6 per cent but not to arrears of more than 6 years.

**ADDED FEATURES.**—The by-laws of the Cudahy Packing Co. provide that if the net earnings are \$1,000,000 or more in any year, preferred dividends shall be paid. If the net earnings amount to \$700,000, at least one-half the preferred dividends shall be paid. If net earnings are less than \$700,000, there is no obligation to pay preferred dividends in that year although they are cumulative. Accrued and unpaid dividends on the 6 per cent participating cumulative preferred stock of the Pittsburgh Coal Co. bear interest at the rate of 5 per cent. Interest, as well as dividends, accumulates.

**APPEAL OF CUMULATIVE STOCK.**—Cumulative preferred stock appeals to some investors as a type of security that resembles a bond but pays a higher return. When all goes well, hopes may be realized. If dividends are paid at the expense of the financial health of the corporation, the cost, even to the holder of the preferred stock, may be excessive. If a series of lean years results in an accumulation that is eliminated only by a readjustment of the capital structure, the holder of common stock may suffer without commensurate gain to the holder of the preferred stock. From the standpoint of management, noncumulative preferred has much to recommend it. Perhaps limitations upon the discretion of the directors might be applied in such manner as to protect the preferred stockholder without hampering the plans of the corporation.

*b. Noncumulative.*—Should the preferred-stock contract specify, either by direct statement or by implication, that dividends shall be noncumulative, those not paid in any year are usually lost forever. In the absence of prohibitory conditions in the contract, directors might declare and pay noncumulative dividends in subsequent years, but the probability of such action is not great. Where such prohibition exists, the discretion of the directors in this respect is eliminated. According to the terms of the contract, noncumulative stock is entitled to dividends; to dividends out of earnings, profits, surplus, or some combination of these; or to dividends out of the profits of the year. Since directors may legally use profits for other purposes, even if sufficient to pay noncumulative preferred-stock dividends, the investment position of such stock is very weak. Its presence is an invitation to the common-stock-minded directors to pass dividends on preferred stock whenever they do not wish to make distributions to holders of common stock.

The discretion of the directors in refusing to pay dividends on non-cumulative preferred stock, even when earned, is illustrated in the case of the Southern Railway Co. For the aggregate of the 4 years from 1939 to 1942, the preferred stock of this company earned nearly the par value of

this stock, \$100 per share. Yet the holders received no dividends during the annual earnings exceeded the prices at which this stock sold on the New York Stock Exchange. When pressed for a resumption of dividends on the preferred stock, the officers of the company stated frankly that the directors proposed to use the period of improved earnings for their corporation to strengthen their financial position. The company had been close to receivership within the preceding decade. The directors resolved to see that future conditions did not find their corporation in an equally vulnerable position.

**KINDS OF NONCUMULATIVE CONTRACTS.**—Noncumulative preferred stock contracts differ from each other in the following important respects: (1) Some give to the board of directors complete discretion in distributing earnings to preferred stockholders, contingent only upon payments to holders of junior issues. In other words, the preferred stockholders have no legal claim to dividends, whether earned or available from previous years or not; they merely have a preference in case the common stockholders are favored with a distribution. (2) Other contracts place upon the board of directors the obligation to distribute to the holders of noncumulative preferred stock whatever earnings are available for that year up to the limit set in the contract. Dividends on the noncumulative preferred stock of Albert Frank-Guenther Law, Inc., are cumulative if earned in any quarter. A loss in one quarter cannot offset a profit in another. In the absence of fraud, the definition of earnings is still left to the board of directors so that the mandatory character of such contracts may be evaded. (3) In unusual cases, the contract provides that the discretion of the board of directors is limited by what amounts to a segregation of earnings, not distributed, into two parts: one, the part earned on the preferred; and the other, the residue. In such cases, common stockholders cannot hope to receive, at a later date, earnings to which holders of noncumulative preferred stock are entitled, even though the earnings are not distributed. This limitation on the discretion of the directors permits them to postpone the distribution of the noncumulative earnings to a subsequent date but prohibits them from distributing the same to the common stockholders. In the absence of an alert group of holders of noncumulative preferred stock, the administration of such a limitation presents practical difficulties. (4) Some contracts create what has been termed "earned cumulative noncumulative" preferred stock. In effect, they provide that noncumulative dividends earned but not paid in any year must be paid before the common stockholders are entitled to any distribution. This creates a hybrid type of preferred stock resembling both cumulative and noncumulative kinds. The earned portion only is cumulative. (5) Finally, some contracts make noncumulative dividends cumulative to the extent supplied by some contingency, such as the presence

of a specified rate of undistributed earnings on such stock. For example, if noncumulative stock earns as much as 6 per cent in any year, it might be entitled to an accumulated credit of 4 per cent to be paid before any dividends are paid on the common stock.<sup>1</sup>

*c. Participating.*—Unless otherwise provided by statute law, contract, or court decision, preferred stock participates equally with common in the distribution of all profits over and above the specified rate on the preferred and an equal rate on the common. In other words, should nothing be stated to the contrary, a 7 per cent preferred stock would receive the first distribution up to that amount; thereupon, the common would be entitled to 7 per cent; thereafter, any further dividends would be distributed ratably among all stockholders, both preferred and common. In many cases, however, the amount and degree of participation by the preferred stock is limited by provisions, the effect of which is to leave, at least in the contract, the lion's share to the common. The exact provisions in this case, as in most others, will be determined by the condition of the company at the time of issue of the stock and by the bargaining powers of the parties in negotiation.

Participating preferred stocks are not commonly used. The Kendall Co. declared on its no-par participating preferred stock, Series A, in addition to the regular payments at the rate of \$6 per year, \$0.92 per share in 1934, \$0.38 in 1935, \$0.10 in 1936, and \$0.89 in 1937. The 4-2 per cent preferred stock of the Seaboard Air Line R.R. Co. is entitled to 4 per cent noncumulative dividends and to an additional 2 per cent, noncumulative, after 4 per cent has been paid on the common. The 4-6 per cent cumulative preference stock of the Sorg Paper Co. is entitled to a dividend of 4 per cent before the common stock receives any dividend and, after the common receives \$5 per share, to an additional 2 per cent. The 7 per cent cumulative participating preferred stock of the Southern Worsted Corp. is entitled to 7 per cent cumulative dividends. In addition, when net earnings for any year exceed 7 per cent on the outstanding common and preferred stocks, the preferred is entitled to a further dividend equal to a prorata share of earnings in excess of 7 per cent up to 10 per cent. If such dividends are not paid, they are cumulative. The ordinary shares of Selfridge Provincial Stores, Ltd. (England), has preference over the deferred up to 7 per cent noncumulative dividend. After each class has received 7 per cent, one-half of the remaining profits distributed goes to each class of stock. Each class is entitled to one-half of the assets in case of dissolution. The preference stock of the International Match Corp. and the preferred stock of the Alabama Great Southern R.R. participate equally with the common stock of their respective corporations. Since no dividends were paid on the 10 per cent participating

<sup>1</sup>Stevens, W. H. S., *The Discretion of Directors in the Distribution of Non-cumulative Preferred Dividends*, *Georgetown Law Review*, January, 1936, pp. 371-396.

Class A stock of the Jones, McDuffee and Stratton Corp. from 1922 to 1937, the participation clause was academic, at least for this period.

In the latest issues of his *Manuals*, Moody lists 250 participating industrial preferred and classified common stocks, 60 for public utilities, and 20 for railroads.

**2. Assets.**—Because it is generally recognized that the capital contributions actually made by common stockholders to their corporations is frequently not very substantial, preferred stock is usually entitled to first consideration in the distribution of the proceeds from the sale of assets, in case the corporation is dissolved. Dissolution may be either voluntary or involuntary. In case a corporation decides to quit business, even though there is no pressure exerted against it by its creditors or otherwise, preferred stockholders are frequently entitled to the par or stated value of their shares, plus accrued dividends and a premium of 5 to 25 per cent, before the common is paid anything. This preference may be accompanied by a limitation to the effect that, once this amount is paid to the holders of the preferred stock, the common stockholders are entitled to the remainder of the proceeds from the sale of assets. Needless to say, voluntary liquidations are not very common.

In anticipation of possible liquidation of a corporation's assets as a result of failure, it is usual to provide that the preferred stock shall have prior claim against the proceeds up to the amount of the par value of the stock—or to a specified amount in case of no-par stock—and the aggregate of dividends in arrears at the time the liquidation takes place, before the common stock receives anything. In some states, this right is given by statute, in the absence of contractual provisions to the contrary.

The preferred stock of the American Window Glass Co. is entitled, in liquidation of the corporation, to receive all accrued dividends and four-seventeenths of the proceeds of the sale of assets, up to \$100 per share. The Class A stock is entitled to receive, subject to the rights and preferences of the preferred stock, all accrued dividends and thirteen-seventeenths of the proceeds of the sale of assets up to \$100 per share. The ratio of preferred to Class A in 1937 was approximately 4 to 7. The 6½ per cent cumulative preferred stock of Lunkenheimer Co. is entitled to \$100 per share if the company is dissolved or liquidated; except that in case it is consolidated or merged with another company before 1940, the preferred is entitled to \$115 per share; and if the company is consolidated or merged after that date, to \$110 per share. The preferred stock of Johns-Manville Corp. is carried on its books at \$120 per share, its liquidation value. The 15 per cent cumulative preferred stock of the Chicago Bridge and Iron Co., par \$100, has preference as to assets in liquidation to \$250 per share. It is callable as a whole or in part at \$250.

While the certificate of incorporation and the preferred-stock certificates of the American Sugar Refining Co. are silent on the question of asset preference, the company's attorneys are of the opinion that, in the event of dissolution, the preferred stock would be entitled to receive, aside from dividends, par value of \$100 per share ahead of the common stock and no more. The preferred stock of the Erie R.R. Co., before its reorganization in 1941, had no preference over the common in the distribution of assets in case of liquidation.

Where a preference is present, its practical value is subject to question at times. Not all corporate failures result in liquidation. The assets may be absorbed by another corporation, perhaps an affiliate. The effect may be similar to liquidation. Yet the form is different and is subject to bargaining between preferred and common stockholders. The organized control of the common stock, represented in the board of directors, usually gives this class of stock a relative advantage over the unorganized preferred stock in such a process. The net result may be that the preferred stock does not receive its stated preference before the common stock is served.

In the recapitalization of the Midland Steel Products in 1930, outstanding 8 per cent participating preferred stock was changed, share for share, into 8 per cent cumulative first preferred stock, with a bonus of two shares of common stock. Each share of outstanding common stock was exchanged for two new \$2 noncumulative dividend shares and one share of new common stock. The noncumulative dividend shares have preference over the common stock in the distribution of dividends at the rate of \$2 per share per annum. In any liquidation, they are not entitled to receive any payment or distribution out of the assets of the corporation. They are not callable and have no voting power except such as is expressly required by law.

In contrast to these shares, the preferred stock of the American Brake Shoe and Foundry Co. carries exclusive right to all residual assets after the common stock has been given a fixed amount.

**3. Control.**—In unusual cases, preferred stock is given the exclusive right to elect representatives to the board of directors. The Ocean City Automobile Bridge Co. has outstanding preferred, voting preference, and common stocks. As long as the corporation's first income 6s are outstanding, only the voting preference stock has voting rights. The preferred stock of the Terminals and Transportation Corp. has exclusive voting right until one-half of such stock originally outstanding has been retired. Thereafter, the common stock is entitled to equal voting rights with the preferred.

In some corporations, efforts are made to maintain a balance of voting power between the two classes of stock. In such cases, if all stock voted, the preferred would cast just as many votes as the common. The common stock of the American Car and Foundry Co. is entitled to one vote for each two shares held. This stock was split two for one in 1925. Up to that time,

common and preferred stock were entitled to one vote per share. The parity of voting power was retained after the common-stock split-up by reducing its voting power per share.

Some corporations make it possible for the holders of preferred stock to dominate their policies by conferring upon preferred stock multiple voting power. The holders of preferred and common stocks of the American States Utilities Corp. vote as a single class, with each preferred share entitled to four votes and each common share, one. The number of shares in 1937 was preferred, 168,000; common, 310,000. This gave holders of preferred stock at least potential control. The preferred stock of the American Tobacco Co. is entitled to four votes per share: common stock, one; and common B, none. The preferred by this means has potential control. The 4,716 shares of preferred stock of the New England Foundries, Inc., are entitled to 10 votes per share. The voting power of the common stock is restricted to a maximum of 40,000 votes as long as any preferred stock is outstanding. Paramount Pictures, Inc., had outstanding in 1937: 148,245 shares of 6 per cent cumulative convertible first preferred stock entitled to 20 votes per share, and 571,751 shares of preferred stock and 2,407,505 common shares entitled to one vote per share. Each share of 7 per cent cumulative preferred stock, par \$100, of the American Furniture Co., Inc., is entitled to one vote. Each share of common stock, par \$1, is entitled to one-twenty-second vote per share.

Contingent control is frequently conferred upon preferred stock when the control exercised by common stockholders fails to provide the dividends expected by the holders of the preferred stock. If dividends have been passed for two consecutive periods, for instance, the preferred stockholders may acquire the right to elect a majority of board members or at times even the whole board. In case of default of eight quarterly dividends, the 6 per cent convertible preferred stock of the American Insulating Corp. is entitled to 10 votes per share. The preferred stockholders of the U.S. Plywood Corp. have no right to vote unless their dividends remain unpaid for a period of 1½ years. They may then elect a majority of the board of directors. If the Albemarle-Chesapeake Co., Inc. should be in default in the payment of eight quarterly dividends on its 5½ per cent Class A cumulative preferred stock, the holders of such stock may, at the option of the holders of 15 per cent thereof, elect a majority of the board of directors. Holders of the 4 per cent cumulative prior-lien stock of the Wheeling and Lake Erie Ry. Co. have the right to elect a majority of the members of the board of directors whenever the company fails to pay 4 per cent dividends for 5 consecutive years. Otherwise this stock has one vote per share. The noncallable 8 per cent cumulative preferred stock of the Universal Leaf Tobacco Co., Inc., is entitled to exclusive voting power on default of dividends for 2 years. In the event such exclusive voting power is exercised and if the company fails

during the next 2 years to earn an amount sufficient to discharge all accumulated dividends on the preferred, with interest, then the company may be liquidated upon the consent of the holders of two-thirds of the preferred stock.

Preferred stockholders frequently possess what is called "veto" voting power. Holders of preferred stock sometimes have veto power over any action of the directors, or the common stockholders, which would change the relative position of the preferred stockholders: *e.g.*, the right to veto a plan to issue securities with prior claim on assets and earnings. It may not always be expedient for the preferred stockholders to exercise such a right. The possession alone is sufficient to put boards of directors on notice to propose such issues only when their justification is evident.

Without the consent of all series of preferred stock, the Pure Oil Co. may not sell its assets, merge or consolidate with another company, create mortgages, etc. Of the three series of preferred stock outstanding, the 238 shares of 5 $\frac{1}{4}$  per cent cumulative preferred alone are noncallable. Unanimous approval of the holders of the 7 per cent cumulative first preferred stock of the Franklin Rayon Corp. is required to reduce the dividends, redemption price, or liquidation rights of the first preferred stock. Two-thirds approval is required to create prior stock or a mortgage or to sell property. Similar protection is given to the second preferred stock.

In attempting to evaluate the rights of preferred stockholders to control the corporations in which they have made investments, several practical considerations must be kept in mind. In case the positive consent of a sizable proportion of the preferred stock is required before any specific action may be taken by the management, mere failure of preferred stockholders to respond to communications addressed to them may block the action. At any rate, the management must convince the required number of holders of the desirability of the action before they can proceed. Where holders of preferred stock merely possess the right to veto actions of the management, but where the preferred holders must act positively to protect their interests, mere passivity may result to the disadvantage of nonassenting but not dissenting holders.

In cases where preferred stockholders have the right to vote as a matter of contract, or where they acquire it because of failure to receive dividends, for example, the value of the right will depend upon two sets of circumstances. Unless the aggregate votes made available to preferred stockholders exceed the aggregate of common-stock votes, the latter may outvote the former and thus practically nullify the voting rights of the preferred stockholders. Since the fundamental objectives of the common stockholders are not the same as those of the holders of the preferred stock, it is not likely that they will vote alike. In the second place, even though the holders of the preferred stock should possess the right to control the



affairs of the corporation—in a contest with the common stockholders—this right is merely academic unless it is exercised. At least the common stock controlled by the officers and directors, represented by direct ownership and by proxies, will be voted. Generally speaking, there is no comparable group to represent the holders of the preferred stock.

**4. Conversion.**—As already indicated in an earlier chapter, various security purchasers react differently to the demands they make of the securities they become interested in. Some, with a motto of “3 per cent and safety,” insist upon buying only high-grade bonds. At the other extreme, some want the thrill that goes to the owner of volatile stock which may skyrocket in price. In between are those so-called “speculative investors” who lack the courage of the plunger but who are not satisfied with the low return on high-grade bonds. In order to attract to the purchase of preferred stock those speculative investors who like to take a chance, provided that it is not too great, preferred stock is sometimes endowed with convertible privileges. The holder thereof may maintain his investment in the preferred stock, or, if and when the common becomes more attractive, he may switch to the latter under the terms of his conversion agreement. Up to this time at least, he can have his cake and eat it, too. Upon conversion, his stock loses its preferences, and he casts his lot for good or ill with the holders of the common stock.

The right of a security holder to exchange one kind of security for another is one that has been used by corporations for many years. Its exercise has been much more common in some periods than in others. While the pattern of conversion may be anything that both the corporation and the security holder can agree upon, the usual procedure is for the security holder to give up relative security of income and of principal in exchange for a hope of greater income and an opportunity for enhancement in the value of his commitment. Being not quite convinced that he should buy the more speculative security at the outset, he prefers to pursue the safer course, with the privilege of shifting to the other type of commitment when his courage increases or when conditions become more favorable to the switch.

Meantime, convertibility of a preferred stock may result in an advantage to the corporation as well as to the stockholder. The mere change from a security that is supposed to pay a regular dividend to one that pays more irregularly gives a decided advantage to the corporation whose earnings may be irregular in character. Frequently also, the security that is convertible contains restrictive clauses in its contract that hampers some of the plans of the corporation. Its elimination by exchange for a less restrictive type of security works to the advantage of the corporation. For example, some stock may not be redeemed at the option of the corporation. If it can be converted into redeemable stock, it may be completely eliminated

at the option of the corporation. In 1935, the 6½ per cent cumulative preferred stock of the Pacific American Fisheries, Inc., was converted into 5 per cent cumulative convertible preferred stock. In 1937, the latter was retired at \$105 per share. In 1922, Julius Kayser and Co. exchanged, for each four shares of \$100-par common, four new no-par \$8 preferred shares and one no-par common share. The preferred shares were retired in 1927, at \$120 per share.

*Exchange vs. Conversion.*—Conversion usually implies a standing right of stockholders to exchange one type of share for another, under conditions stipulated in the stock contract. When preferred stock is callable, the corporation may elect to offer a new contract to supersede the existing one, as an alternative to repurchasing the outstanding stock. Perhaps this should be designated exchange rather than conversion. In offering 5 per cent cumulative preferred stock in 1935, the Loose-Wiles Biscuit Co. gave the holders of outstanding 7 per cent preferred stock the right to purchase at 101 as many shares of the former as they would be able to purchase with the proceeds of redemption of the latter at \$120 per share. In 1936, the Savannah Sugar Refining Corp. offered the holders of 29,373 shares of 7 per cent preferred stock the option of exchanging their stock for common, share for share; for 5 per cent preferred, share for share; or of having it retired at \$110. Holders of all but 52 shares exchanged for common. These 52 shares were retired. In 1937, the Goodyear Tire and Rubber Co. of California offered 4½ per cent noncumulative second preferred stock in exchange for 7 per cent preferred, share for share. The holders of over 96 per cent of the stock accepted the offer.

On occasion, preferred stock may be reclassified as an alternative to exchanging other stock for it. In 1945, Gimbel Bros. reclassified its \$6 preferred stock to entitle it to only \$4.50 per share. To induce the acceptance of this plan by the stockholders, what amounted to 1½<sub>0</sub> share bonus was offered. In his letter to the holders of the \$6 stock, the president of the company said in part: "The Directors recommend the adoption of the proposed plan as being in the best interest of the corporation and the stockholders. The alternative would in all probability be the refunding of the present \$6 preferred stock by calling for redemption and providing the funds therefor in whole or in part by public or private sale of other securities."

*Conversion Ratios.*—When preferred stock is converted into common, for example, the number of shares of common that may be obtained for each share of preferred follows a wide variety of patterns. In earlier days, there was a tendency to convert share for share. When conversion really became a part of the stock-selling game, it assumed all kinds of ratios. Many plans give encouragement to early conversion, by making later conversions less

advantageous to the holders of preferred stock. The preferred stock of Spiegel, Inc., is convertible into common at the option of the holder at any time before 1947 or, in case of earlier redemption, before the fifth day prior to the redemption date, at the following ratios: three and one-third shares of common for each share of preferred prior to 1940, two and six-sevenths shares thereafter to 1943, and two and one-half shares to 1947. Based upon the \$100-par value of the preferred, these conversion ratios are equivalent to a price of \$30, \$35, and \$40 per share, respectively, for the common stock. One share of the 5 per cent preferred stock of the Fishman Co., Inc., is convertible into seven shares of common prior to 1938, six shares to 1939, five shares to 1940, and four shares during 1941.

*Common into Preferred.*—Occasionally, conversion results in the replacing of common stock by preferred. In 1930, the directors of Prudential Investors, Inc., offered one share of \$6 cumulative preferred stock for each four and one-half shares of common, up to a maximum of 50,000 shares of preferred to be issued for this purpose. Common stock was not on a dividend-paying basis. Up to this time the company had no preferred stock outstanding. In 1936, the Copley Press, Inc., exchanged for each two common shares one new 6 per cent preferred share, par \$100, and one new common share, par \$100. This stock is closely held.

*Preferred into Bonds.*—Of an original \$2,000,000 issue of 6 per cent preferred stock of the New York, Ontario and Western Ry. Co., all but \$4,000 had been converted into first mortgage bonds by 1936.

*Option of Corporation.*—In rare instances, stock is convertible at the option of the issuing corporation. The 4 per cent noncumulative second preferred stock of the Reading Co. is convertible, at the option of the company, one-half into first preferred and one-half into common.

*Automatic Conversion.*—A case of automatic conversion is as follows: After dividends aggregating 100 per cent of par value (\$1) have been paid on the preferred stock of the Buckeye Union Oil Co., this stock ceases to be preferred and automatically becomes common. Up to 1931, a total of 39 per cent had been paid. The depression interrupted the further payment; and, in 1936, a voting trust, to expire in 1949, was organized by the holders of 55 per cent of the preferred shares and 39 per cent of the common.

*Acceleration of Conversion.*—Conversion is frequently accelerated by a call for redemption. By this process the holders are induced to exercise their conversion rights rather than lose their stake in the corporation. In 1936, the \$6.50 preferred stock of the Ludlum Steel Co. was called at \$110 per share. It was convertible into common stock at the ratio of five shares of common for one share of preferred. After the call, 43,913 preferred shares were converted, and only 347 shares were redeemed. The high price for the common stock in 1936 was \$35 and the low, \$22¼. In 1937,

the United-Carr Fastener Corp. called its preferred stock at \$23 per share. The entire issue was converted into common stock. In 1936, the \$3.50 cumulative preferred stock of the Eastern Steamship Lines, Inc., was called for redemption at \$55 per share. Holders had the right to exchange their stock for new \$2 cumulative convertible preferred stock, no-par, share for share. Holders of four-fifths of the outstanding stock accepted the offer.

**Uses of Conversion Privilege.**—It has already been suggested that the preferred-stock conversion privilege is used by the corporation to attract security buyers not yet ready to become common stockholders. In periods of prosperity, conversion rights are used freely because at that time not only speculators but also the class of security buyers designated as "speculative investors" are looking at the advantages of common-stock ownership. Speculators will make their commitments directly in common stock. Speculative investors prefer to temporize with their final positions; but nevertheless, they like to buy preferred stocks that they may convert, at their discretion, into the more volatile class of securities. In the decade of the 1920's those issues of preferred stock that carried conversion rights, or other forms of sweeteners, had a wider following than those which lacked this additional feature of sales promotion.

**Knight's Study.**<sup>1</sup>—Earl L. Knight made an exhaustive study of all preferred stocks whose distributions were recorded in the financial press from 1900 through 1937. He found 1,246 corporations that had disposed of 1,393 preferred stock issues, with an aggregate of 107,200,000 shares, having a total par or stated value of more than \$5,128,000,000. The distribution of these issues by industrial classification of corporations was as follows:

Type of industry	Number of issues	Number of shares (000 omitted)	Amount (000,000 omitted)
Industrial.....	1,049	74,769	\$3,334
Public utility.....	116	11,528	607
Financial.....	209	16,964	799
Railroad.....	19	3,936	387
Total.....	1,393	107,200	\$5,128

The proportion of the dollar volume of all preferred-stock issues that were convertible varied from 4.4 per cent in 1921 to 71 per cent in 1929. The percentage for each of the years from 1919 to 1931 was as follows:

<sup>1</sup> Submitted in partial fulfillment of the requirements for the Ph.D. degree at Ohio State University in 1940 under the title "Convertible Securities." Unpublished.

Year	Percentage of Preferred Stock Convertible
1919	15.0
1920	15.9
1921	4.4
1922	34.5
1923	17.4
1924	11.5
1925	21.0
1926	40.8
1927	31.2
1928	48.1
1929	71.0
1930	62.0
1931	38.1

Since the total amount of preferred stock issued after 1931 was small, the proportions that carried conversion privileges were not significant.

For the period from 1919 to 1937, 27.7 per cent of the preferred-stock issues distributed were originally rated by Moody. Of the 324 issues, Moody's ratings were as follows, by numbers of issues: Aaa—2; Aa—5; A—6; Baa—37; Ba—100; B—106; Caa—48; Ca—14; C—5; D—1. In other words, more than half were rated B or lower, and nearly all were rated not higher than Ba.

Nearly three-fourths of all preferred-stock issues are convertible at any time from their date of issue to the date of their redemption. Limited-privilege periods, with either a waiting period at the beginning, before the privilege becomes effective, or a cut-off date before the stock is redeemed, applied to only 27.4 per cent of all issues studied. The length of the waiting period, occurring in only 7.6 per cent of the cases, ranged from 1 month to 13 years, with 1 year the most common. Curtailment of the conversion period, so that the privilege lapsed before the redemption of the stock, occurred in about one-fourth of the cases studied. Less than 2 per cent of all issues had conversion periods abbreviated at both the beginning and the end.

The call or redemption of a convertible preferred-stock issue automatically terminates the conversion privilege. In about four-fifths of the cases, however, conversion was permitted up to the redemption date. In the other fifth the privilege lapsed before the redemption date. In 83 per cent of the issues that permitted conversion up to the redemption date, the period left for conversion after the issue of the call for redemption was 10 days or less. For half of these, the time allowed for conversion was 5 days or less. The minority of 17 per cent of the cases allowed 15 to 60 days for conversion after the issue of the call for redemption, with 30 days

most common. In only slightly more than 1 per cent of all cases did the period run longer than 30 days.

Antidilution clauses for the protection of convertible preferred stocks appeared for the first time in an issue floated by the Paramount Famous Players Lasky Corp. in 1919. Dilution means reducing the effectiveness of the conversion privilege. Suppose, for example, that a share of preferred stock is convertible into 2 shares of common. If the common stock should be split into a larger number of shares, or if a stock dividend is distributed to common stockholders before the preferred stock is converted, the conversion rights would be diluted unless the number of shares into which the preferred stock is convertible is proportionally increased. As late as 1926, only one issue out of 12 contained any protection for the preferred stockholders. This proportion increased intermittently until, for the first time, a majority of preferred stocks issued in any one year were given such protection in 1936. Some so-called "protective" clauses—such as those which merely require notice to preferred stockholders in case of changes that will result in the dilution of their shares—offer no real protection but merely force conversion instead. In other cases, varying degrees of protection are provided, from only limited to full and automatic protection against the effects of new stock issues.

*Current Uses.*—The most recent compilation of preferred stocks shows that the predominance of convertible issues lies in the field of industrial corporations. The latest edition of Moody's *Manuals* lists more than 400 industrial convertible preferred and classified common stocks, 45 for public utilities, and only 13 for railroads.

**5. Safeguards.**—Since those who purchase preferred stock indicate thereby their unwillingness to assume the greater risks that are expected to accompany ownership of common stock, they want to make sure that their relative protection shall be maintained. This means that certain assurances are sometimes written into the preferred-stock contract. On the one hand, they represent assurances to the holders of the preferred stock; but on the other, they result in restrictions upon the freedom of action by the management of the corporation. The problem to be solved becomes a matter of balance between proper protection to the preferred stockholder, without unduly hampering the future operations of the corporation. The most common of these safeguards are discussed briefly.

*a. Bonds.*—Sometimes the corporation agrees not to mortgage its property. In other contracts there is a provision that bonds may not be issued without the consent of a large proportion—sometimes as high as 75 per cent—of holders of the preferred stock. Again, preferred stockholders are merely given the veto mentioned above. With total assets of approximately \$83,000,000 the Kroger Co. as of December, 1946, had outstanding \$50,000 of 6 per cent preferred stock and \$46,400 of 7 per cent preferred

stock, both noncallable. The company may not issue any bond or mortgage indebtedness without the approval of the holders of three-fourths of both first and second preferred stock. Without the consent of the holders of three-fourths of first and second preferred stock, American Hair and Felt Co. may not create any mortgage, lien, or encumbrance except leases, purchase-money mortgages, and customary commercial-paper loans.

*b. Preferred Stock.*—In some cases, no stock may be issued having priority over, or being on a parity with, the preferred stock outstanding without the consent of the holders of a large proportion thereof. The provisions of the preferred stock of the Amalgamated Sugar Co. include a restriction against the issue of additional stock equal or prior to the preferred without the consent of the holders of three-fourths of the preferred stock outstanding, and then only if the average net earnings available for dividends for the three preceding fiscal years equal three times the amount required for dividends on the preferred stock outstanding and to be issued. The Davidson Waterloo Co. agreed not to issue more than nine shares of 5 per cent cumulative preferred for each share of common outstanding. The protective features of the preferred stock of the Abercrombie and Fitch Co. include the following: No new shares of preferred stock in excess of 21,000 shares shall be issued unless the net earnings of the company, plus the net earnings of the property to be acquired, if any, for a period of 12 successive months ending 90 days before such issue, amount to not less than two and one-half times the aggregate annual dividend requirements on the outstanding preferred stock and that to be issued. As an alternative, five times such dividend requirements must have been earned in the 24 months preceding the issue.

*c. Maintenance of Ratios.*—Specific ratios are sometimes provided for in preferred-stock contracts for the purpose of maintaining or strengthening the protection of preferred stockholders. Such ratios include current assets to current liabilities, net surplus to capital, dividends to net earnings, etc.

*d. Dividend Reserves.*—A further protection for preferred stock takes the form of the establishment of reserves for future dividends on this class of stock, before any distribution is permitted to common stockholders. This induces the corporation to use profits of prosperous years to provide income for the preferred stockholders during the lean years instead of distributing them to the holders of common stock. Having set aside \$400,000 out of surplus to cover its dividend requirements for the year 1931, the Bon Ami Co. was able to declare dividends on its Class A and Class B stock in spite of the business decline. Dividends on the 8 per cent convertible preferred stock of the Barahona Sugar Corp. are cumulative if earned. In 1936, the company carried a dividend reserve amounting to \$382,398, representing the undistributed earnings for the years 1930, 1934, and 1936.

The consent of the holders of at least three-fourths of the outstanding preferred stock of Barker Brothers Corp. must be obtained before the corporation may create or authorize any additional class of stock or any obligation convertible into any shares of any class other than common stock; increase the authorized amount of preferred stock or any class of stock other than common; amend, alter, or repeal any provision with reference to rights or preferences of preferred stock; sell or convey all or substantially all the business or property of the company; consolidate or merge with any other corporation; create any mortgage, lien, or charge of any kind on any part of the real or personal property of the company or any subsidiary except purchase-money mortgages or mortgages not in excess of 76 per cent of cost or the fair value of the after-acquired property; renew or extend such mortgages, or loans made in the course of regular business, maturing within 12 months; guarantee any obligation as to principal or interest or payment of dividends or retirement of any stock of any other corporation; sell or convey any stock, or all the property or major part thereof, of any subsidiary, or merge or consolidate any such subsidiary with any other corporation.

*e. Common Stock.*—Since the equities of the preferred stockholders can be diluted easily by distributions to holders of common stock, some corporations prohibit dividends to the latter when: the result would be to reduce the ratio of assets (particularly net tangible assets) to the amount of preferred stock below a specified figure; the amount of working capital or its ratio to the outstanding preferred stock drops similarly; or a drop in surplus or ratio of surplus to preferred dividend requirements is experienced. For the purpose of affording further protection to the \$3-par preferred stock of the Schmidt Brewing Co., Inc., holders of the closely held common stock escrowed 60,000 of the 160,000 shares outstanding until earnings for 1 year are equal to \$1 per preferred share; the company redeems the preferred stock; preferred dividends paid aggregate \$3.75 per share, plus 10 per cent per annum from date of issuance; or the secretary of state of Illinois approves release of the escrowed stock. Owners of the escrowed shares waive the right to dividends until the shares are released.

If such safeguards are too numerous and too rigid, they may hamper the future development of the corporation. If they are accompanied by the callable privilege—to be described under the subject of limitations—they may be overcome. Otherwise, appeals can always be made to the stockholders for a change in the contract. These are usually successful, particularly if accompanied by some advantage not already possessed by the preferred stockholders.

### QUESTIONS AND SUGGESTIONS

1. How did preferred stock originate? Is its origin of historical significance only, or is it currently important?
2. What is a preference? What preferences are commonly given to preferred stock?



## CHAPTER VIII

### STOCKS WITH PREFERENCES AND LIMITATIONS

(Concluded)

#### II. LIMITATIONS

**Meaning.**—As indicated in the preceding chapter, preferences given to preferred stock are usually accompanied by the imposition of limitations. This means that, where the holder of preferred stock is placed in a relatively favorable position on one subject, in comparison with common stockholders, the latter may be given a corresponding advantage on some other subject. The most common class of limitations results from the exchange of control for relative security with respect to income distribution and to preference against assets in case of dissolution of the corporation. Other limitations in common use are listed here also.

1. *Control.*—Usually preferred stock carrying a high preferential dividend rate and having preference as to assets in case of dissolution is denied the right to vote except under the conditions already described. In the absence of such limitation, the preferred stock votes ratably with the common. From one point of view, this absence of control seems to place the preferred stockholder at a great disadvantage in letting common stock dictate corporation policies. Practically, however, possession of the right to vote and wise and effective use of such right are two quite different things. The voting privilege is hardly a sufficient weapon for a preferred stockholder to use against an incompetent or a dishonest board of directors.

It is interesting to note that preferred stocks issued by railroads usually have no limitation on their right to vote. Most of them pay low dividend rates which are not cumulative. Most of them resulted from reorganization when bonds were exchanged for preferred stock. Having given up their rights to a fixed income, the new stockholders acquired in their place the right to vote ratably with other stockholders. That is why railroad preferred stock commonly enjoys the right to vote. Holders of industrial preferred stocks, on the other hand, usually obtained their securities by purchase for cash. They are considered to be merely capital contributors, like bondholders. It is not strange that they are commonly denied the right to control, except in emergencies or except to veto some action that directly affects their interests. Indeed one of the reasons why preferred stocks have been used in some cases is the desire on the part of management to secure

capital from those who do not demand a voice in the determination of the corporation's policies.

The preferred stock of the American Radiator and Standard Sanitary Corp. has no voting power, except such as is provided by statute. This represents a common practice in some states. Occasionally, the desire to issue nonvoting preferred stock is opposed by public authority. When the New York State Electric and Gas Corp. petitioned the New York Public Service Commission for the right to issue 100,000 shares of 5 per cent \$25-par preferred stock without voting rights, the commission rejected the petition as "inexcusable and against public policy." The prior preferred stock of the American Zinc, Lead, and Smelting Co. has equal voting power with the preferred and common stock on all questions except such as affect liens, stock issues, and dividends upon capital issues junior to the prior preferred. The preferred stock has corresponding protection and limitations.

**Kinds of Voting Rights.**—Preferred stocks possess a variety of kinds of voting rights, according to the statutes and the regulations governing each corporation.<sup>1</sup> Of 765 preferred-stock issues of industrial corporations investigated by Beneke, approximately 20 per cent possessed full and equal voting rights with common stock. In a few cases, the holders of preferred stock had no right to vote on the increase of any stock junior to it. In the case of 24 per cent of the issues studied, the preferred stock ordinarily has no voting right. Such rights are acquired only when one or more of the following contingencies arises: default in preference-stock dividends; default in the maintenance of specified types of assets, usually current; failure to maintain earnings at a specified level; defaults in sinking-fund payments.

Voting rights acquired when any of the above contingencies occur vary a great deal. In some instances, the preferred stockholders simply acquire full voting rights. Alternatives are to elect: additional directors; a portion of the regular directors, but less than a majority; a majority of the directors; or all directors. Approximately 7 per cent of all preferred-stock issues studied possess no voting rights under any circumstances. About 9 per cent have full voting rights ordinarily, plus additional voting privileges under specified conditions.

Veto voting privileges are sometimes granted to preferred stockholders, which give them the right to pass on such questions as creation of a mortgage or other lien on the assets of the corporation, creation of new stock with claims equal or prior to those of the outstanding preferred, increase in the amount of existing preferred stock, issuance of any type of funded debt, change in the preferred-stock contract, and sale or lease of a substantial portion of the assets. The clauses in preferred-stock contracts dealing with

<sup>1</sup> The following analysis is adapted from Herman H. Beneke, "The Voting Right of Corporate Stocks," submitted in partial fulfillment of the requirements for the Ph.D. degree at Ohio State University, 1940, pp. 146ff.

such subjects provide either that a specified proportion of the preferred stock must be voted in favor of them, or that the corporation may not do certain things if a specified portion of the preferred stock is voted against them. The positive approach that requires the specific approval of the preferred stockholders probably gives them better protection.

The distribution of voting rights of 652 selected industrial corporations having 765 preferred-stock issues outstanding was as follows:

Kind of Voting Right	Percentage of Preferred Issues
Full voting right .....	35.0
Nonvoting, plus contingent full voting right .....	23.9
Nonvoting, plus contingent right to elect directors .....	25.1
Nonvoting .....	7.1
Full voting right, plus contingent variable voting .....	8.9
Total .....	100.0

The distribution of voting rights of 100 selected public utility corporations having 160 preferred-stock issues outstanding was as follows:

Kind of Voting Right	Percentage of Preferred Issues
Full voting right .....	31.3
Nonvoting, plus contingent full voting right .....	37.0
Nonvoting, plus contingent right to elect directors .....	1.6
Nonvoting .....	24.1
Full voting, plus contingent variable voting .....	6.0
Total .....	100.0

Corresponding distribution of 64 issues of preferred stocks of 50 selected railroad corporations was as follows:

Kind of Voting Right	Percentage of Preferred Issues
Full voting right .....	92.2
Nonvoting, plus contingent full voting right .....	6.1
Full voting, plus contingent variable voting .....	1.7
Total .....	100.0

**2. Income.**—Once preferred stockholders have been paid the dividends to which they have a preference, they are customarily limited to such amounts. Seldom are they permitted to participate in the distribution of excess earnings. Since the dividends that they actually receive are supposed to be conditioned upon the presence of earnings, current or accumulated, and, further, upon the willingness of the directors to declare in dividends whatever earnings are available, the position of preferred stockholders with respect to income is somewhat baffling. If the corporation is unsuccessful, no dividends will be available to either preferred or common stockholders.

If it is only moderately successful, the holders of the preferred stock may enjoy an advantage over those who own the common. Marked success usually results in distinct advantages for the common stockholders because of the income limitations on the preferred stock.

3. *Redemption*.—While preferred stockholders may receive the right to convert their holdings into common stock, boards of directors often retain the right to call preferred stock at their option. This means that, at the discretion of the directors of the corporation, they may demand that the holders of preferred stock present it for cancellation, at a price made a part of the stock contract. The agreed price may be at a premium of a few points above the par or stated value of the stock. When such a call is made, the holders of preferred stock have no alternative but to present it for redemption. All their rights expire with the call, except the right to receive the call price. No more dividends will be paid, and voting rights, if any, are canceled. In case, for any reason, stock is not presented for redemption, the corporation is supposed to reserve an amount necessary to pay the call price, if and when the stock is presented for redemption. If high-dividend stock becomes burdensome or if the safeguards thrown around preferred stock to protect its investment status cramp the plans of the directors for future expansion, the call privilege may be exercised, and the preferred stock will be retired. In other words, at a time when preferred stockholders want most to retain their position in the corporation, they may have it taken from them. Since there have been few railroad preferred stocks issued in recent years, the call privilege is not so commonly used in this industry as it is among industrial and public utility corporations.

**Sinking Funds**.—Not only do some corporations have the right to call their preferred stock for redemption, but the stock contract distinctly contemplates the retirement of this stock. Even sinking funds, to be set up from earnings, are provided for this purpose. Some are compulsory on the part of boards of directors, whereas others are merely permissive. The requirement that boards of directors shall establish a sinking fund to retire the preferred stock before paying any dividends on the common is not an unmixed blessing. At the outset, the credits to such sinking fund may strengthen the position of the preferred stockholders. Continued credits to the fund may cause their undoing, since a large sinking fund may invite its use in retiring the stock at a time when its investment status is high.

Dewing found that of 543 industrial preferred stocks issued in the period from 1925 to 1930, 56.2 per cent had sinking-fund requirements. Only 2.3 per cent of public utility preferred stocks issued during the same period provided for sinking funds.<sup>1</sup> The sinking-fund provisions of the preferred stock of Abercrombie and Fitch Co.—one-eighth of net earnings after provision for preferred dividends—are operative only when cumulative

<sup>1</sup>Dewing, A. S., "A Study of Corporation Securities" (New York, 1934), p. 162.

dividends on this stock are not in default, although the sinking-fund requirements are cumulative. Preferred stock called by lot, to satisfy sinking-fund requirements, is forfeited to the company if not offered for redemption in 6 years. In the reorganization of the Foster and Kleiser Co., the new Class A preferred-stock sinking-fund installments were fixed at 5 per cent of the first \$500,000 of net profits and 10 per cent of all above that amount. The preferred stock of Spiegel, Inc., \$100 par, issued in 1937, is redeemable at the option of its board of directors in whole or in part at any time, on 45 days' notice at \$105 per share, if redeemed before 1947, and at \$102.50 thereafter. In each case, accrued dividends will be added. Beginning in 1947, the corporation is obligated to redeem or purchase for retirement 3 per cent of its preferred stock each year.

Sometimes the sinking-fund provision is added to preferred stock to meet the conveniences of the corporate management. The capital obtained from the sale of the stock may not be needed permanently in the business. The provision for a sinking fund affords an orderly method of retiring the stock. At the time the plan is drawn up, there is full expectation that it will be administered as written. But if adverse economic conditions prevent the fulfillment of this part of the contract, it is usually not difficult to secure a waiver of sinking-fund requirements from the holders of the preferred stock. Such request would ordinarily come at a time when other investments are having difficulty in maintaining their contractual obligations. The stockholders are conditioned to expect disappointments and requests for easing up in business requirements.

Many preferred stocks, especially those of relatively small corporations, are not listed on any stock exchange. Hence there is no possibility of anything that resembles an open market for this class of stock. The operation of sinking funds may provide a market for those stockholders who may wish to dispose of their stock. Since the sinking fund is set up to retire the preferred stock, it is natural to expect corporate directors to use the fund to buy up this class of stock, by the use of tenders or otherwise. Even though sinking funds are not provided for, boards of directors sometimes use surplus funds to buy their preferred stock.

**Redemption Cases.**—During the late 1930's and early 1940's a veritable flood of preferred stock was redeemed, sometimes from the use of idle cash and sometimes from the proceeds of the sale of other securities. This was a period of cheap money. Many corporations in effect refunded one issue of preferred stock, bearing a relatively high rate of dividends and issued in its place another preferred-stock issue bearing a lower dividend rate. In other cases, preferred stock was changed into common stock. Sale of treasury assets and the use of short-term loans also provided funds for this purpose. Other sources of funds were also used, as the following illustrations show.

Among the corporations that retired their preferred stock during the late 1930's were the following: Black and Decker Manufacturing Co., 8 per cent cumulative preferred stock, par \$25, redeemed at \$27; Allen Industries, Inc., \$3 cumulative preference stock, at \$40; J. C. Penney Co., 6 per cent, at 103; Bohn Aluminum and Brass Corp., 8 per cent, at 105; Arrow Hart and Hegeman Electric Co., 6½ per cent, at 108; American Steel Foundries, 7 per cent, at 110; Walgreen Co., 6½ per cent, at 113; Chrysler Corp., 7 per cent, at 115; Standard Brands, Inc., 7 per cent, at 120; Fiberloid Corp., 7 per cent, at 125.

Some redemption plans are not so simple as the use of treasury cash. The American Rolling Mill used bank loans to retire its 6 per cent preferred stock, refunding such loans from a later issue of serial preferred stock. Standard Brands, Inc., incurred bank loans to retire its preferred stock at 120. A month later it sold \$4.50 cumulative preferred stock at 95, using a part of the proceeds to retire its bank loans. The U.S. Pipe and Foundry Co. liquidated its bank loans, created to retire its preferred stock, from the proceeds of the sale of 3½ per cent convertible debentures.

Parent companies take advantage of favorable money markets to redeem the preferred stocks of their subsidiaries. The Wayne Pump Co. retired the 5 per cent cumulative preferred stock of the Wayne Co. in 1936. In the same year, R. H. Macy and Co., Inc., redeemed at 110 the 6½ per cent preferred stock of L. Bamberger and Co. and the 7 per cent preferred stock of Lasalle and Koch Co. The Standard Oil Co. of New Jersey sold 25-year 3 per cent debentures to enable its subsidiary, the Standard Oil Export Corp., to redeem 5 per cent preferred stock at 110.

The 7 per cent cumulative preferred stock of the Parker Rustproof Co. is redeemable at par on Aug. 23, 1946, but the company has the option of retiring it at any time by purchase in the open market. The par value of this stock is \$10 a share. In the annual report of the company for 1936, the directors made the following offers for this stock (plus accrued dividends in all cases):

Feb. 23, 1937 .....	\$13.30
Aug. 23, 1938 .....	12.82
Aug. 23, 1941 .....	11.84
Aug. 23, 1944 .....	10.77
Aug. 23, 1946 .....	10.00

Adjustment in prices will be made in interim periods to conform to a 3 per cent yield basis. The report states that all stock not voluntarily surrendered prior to Aug. 23, 1946, will be called at par on that date. With the 8 per cent cumulative preferred stock of the Weill (Raphael) and Co. eligible for retirement at 110 in 1938, the company offered \$118 per share in 1937. It had built up a reserve for preferred-stock-redemption premium sufficient to retire a majority of the preferred stock at \$118.

*Gradual Retirement.*—The sinking-fund provision for the retirement of the noncallable preferred stock of the Mathieson Alkali Works, Inc., contemplates continuous retirement of the preferred stock at not to exceed 110. If stock is not available at that price, the sinking fund need not be built up higher than 20 per cent of the preferred stock outstanding. After touching \$110 in 1934, the price remained above that figure through 1936. Meantime the sinking fund has been built up above the 20 per cent requirement. The stockholders of the American Crystal Sugar Co. authorized its directors to make open-market purchases of its 6 per cent preferred stock at their discretion at prices not to exceed 105. Following a similar plan, the Adams-Mills Corp. reduced its preferred stock from \$1,750,000 to \$500,000.

*Tenders.*—Some corporations redeem preferred stock on tenders. In 1937, the General Public Service Corp. asked for tenders of its preferred stock at prices not to exceed \$78 per share. It had outstanding both \$6 and \$5.50 preferred stock. The American States Utilities Corp. has contracted to put into a sinking fund, for the retirement of its preferred stock, one-fourth of the annual net earnings after preferred dividend requirements and to apply such funds within 90 days to the retirement of preferred stock by redemption, open-market purchases, or tenders.

### III. CLASSIFIED STOCK

**Meaning.**—In the consideration of the subject of stock up to this point, we have assumed the existence of only one class of common and one class of preferred for any single corporation. In both English and American experience it is not uncommon to find more than one kind of common stock, or more than one kind of preferred, or both, issued by the same corporation. Where such practices are followed, the stock may be known as classified stock, or other names may be used to distinguish one issue from another.

**Classified Preferred Stock.**—American corporations sometimes use two or more classes of preferred stock, such as first preferred and second preferred; or preferred A, preferred B, etc. As a rule, the first in order possesses certain dividend preferences. Each of the preferred stocks, in turn, has dividend preference over the common stock. In return for the preference in dividend payments, the first preferred may be restricted to a lower rate than the second preferred. Preferred stock, in American experience, is seldom classified except in the refinancing processes made necessary by consolidations and reorganizations.

The classic American illustration of multiple issues of preferred stock was the Associated Gas and Electric Co. Its 14 classes of stock, including 11 issues of preferred, 2 of classified common, and 1 of common were as follows: \$3.50 cumulative preferred, original series, no-par; cumulative preferred, no-par, with respective rates of dividend \$5, \$5.50, \$6, \$6.50, and \$7; cumulative preference, no-par, with respective rates of dividend \$4, \$5, \$5.50,

\$6, and \$6.50; Class A, par \$1; Class B, par \$1; and common. Class B has sole voting rights except for the contingent rights given to other series. The Boston and Maine R.R. Co. has outstanding the following classes of stock: (1) 7 per cent cumulative prior preference. (2) Cumulative first preferred, entitled to the following dividend rates, if earned: Class A, 5; B, 8; C, 7; D, 10; E, 4½. (3) Noncumulative preferred. (4) Common. The Public Service Corp. of New Jersey has outstanding the following classes of stock: (1) 8 per cent cumulative preferred, \$100 par; (2) 7 per cent, \$100 par; (3) 6 per cent, \$100 par; (4) \$5 cumulative preferred, no-par; and (5) common, no-par. The Wabash Ry. Co. has outstanding 5 per cent profit-sharing preferred A stock; 5 per cent convertible preferred B; and common. This profit-sharing stock is participating but not cumulative. The Kansas, Oklahoma and Gulf Ry. has outstanding four classes of preferred stock, having respectively, first, second, third, and fourth preference as to assets and dividends.

The classes of stock of the Eastern Massachusetts Street Ry. Co., in the order of preference, are as follows:

Classes of Stock	Shares Outstanding 1936
Sinking-fund 6 per cent cumulative .....	130
First preferred 6 per cent cumulative .....	41,399
Preferred B 6 per cent cumulative .....	29,978
Adjustment 5 per cent cumulative .....	87,112
Common .....	84,880

*Serial Preferred.*—In recent years, preferred stock has been issued in series by some corporations in much the same manner as serial bonds. Having already issued \$6 cumulative stock, series A, the Mead Corp. took advantage of a more favorable money market to issue its series B with a cumulative dividend of only \$5.50 per share. Series B consisted of 50,000 shares and sold at \$99 per share. Both series A and series B are redeemable in whole or in part on any dividend date at \$105 per share upon 30 days' notice. Ten per cent of net earnings after the payment of dividends upon preferred stock—but not more than \$5 per share per year—is set aside as a sinking fund for the redemption of preferred stock irrespective of series. The Automobile Finance Co. has outstanding both 7 per cent and 6 per cent preferred stock, equal in all other respects.

Although having the right to issue preferred stock in series, with terms and provisions to be determined by its board of directors, the Allied Stores Corp. has given holders of outstanding preferred stock a veto power over this blanket authority in the following manner: Unless 30 days' notice is given to holders of outstanding 5 per cent preferred stock and if holders of more than one-third of such stock object, the company may not increase the authorized preferred stock or do anything else to dilute the interests of the



preferred holders, including amendment, alteration, or repeal of any rights of outstanding preferred stock.

The Ohio Edison Co. has outstanding the following series of preferred stock, all no-par, nonvoting, with a liquidation value of \$100 per share:

Series	Shares
\$5.00	1,367
6.00	197,585
6.60	22,133
7.00	58,341
7.20	3,990

The Savannah Electric and Power Co. has outstanding the following classes of preferred stock: 8 per cent cumulative debenture stock, series A, par \$100; 7½ per cent cumulative debenture stock, series B, par \$100; 7 per cent cumulative debenture stock, series C, par \$100; 6½ per cent cumulative debenture stock, series D, par \$100; 6 per cent cumulative preferred, par \$100. Although the 8 per cent, the 7½ per cent, and the 6 per cent stock are entitled to four votes per share, it would require a high degree of concentration of voting strength to outvote the parent company, which owns all the common stock.

**English Experience.**—English corporations make much less use of bonds than American corporations. Their financial plans are frequently complicated with various classes of stock. As many as 22 different classes of stock have been found in use by the same English corporation. The differences constitute preferences and limitations on income for the most part. Even founders' shares, defined earlier, may at times partake of the nature of preferred stock because of the special income and voting privileges given them. The number of such shares issued by one corporation is usually small so that the price per share may become very high. In some cases, provision is made for equal division of earnings between the aggregate of ordinary stock and the aggregate of founders' shares, after the contractual obligations to the preference shares have been met.

The Southern Ry. Co. (England) has outstanding 4 per cent perpetual debenture stock, 4 per cent redeemable debenture stock (1962–1967), 5 per cent perpetual debenture stock, 5 per cent guaranteed preference stock, 5 per cent redeemable guaranteed preference stock (1957), 5 per cent preference (contingent) stock, 5 per cent redeemable preference stock (1964), preferred ordinary stock, and deferred ordinary stock. Lever Brothers, Ltd., uses the following classes of stock: debenture, 7 per cent cumulative preference, 8 per cent cumulative A preference, 20 per cent cumulative A preferred ordinary, and ordinary. The Colon Development Co., Ltd. (England), has the following stocks outstanding: 6 per cent preference, income A, income B, and ordinary. The preference stock and the A and B income stocks have no par designated, each certificate representing a stated

principal amount. Each of them is entitled to 5 per cent cumulative dividends and to participate in excess income. The ordinary shares have a par of 1s.

**Classified Common Stock.**—In the period following the First World War, there came into use in American corporation finance the practice of classifying common stocks. This was not a new invention but merely an adaptation of well-established English practice. Throughout the decade of the 1920's, the popularity of classified common stocks grew to a crescendo in 1929 when the greatest number of such issues were placed on the market. Since that date, there has been a distinct decline in their use. Not only have few new issues been floated, but a considerable number of those put out in the 1920's have been recalled, with a single issue of common to take their place. There are several reasons to account for the temporary popularity of classified common stocks. In the first place, legal handicaps sometimes placed upon the issuance of preferred stock invited the use of a substitute that was not subject to these restrictions.

In effect, classified common stock constitutes a means of issuing preferred stock without designating it as such. Since its various issues may be given such preferences and be subject to such limitations as its originators see fit to endow it with, its use also fitted into the plans of boards of directors who wished to concentrate voting power in the hands of the holders of a relatively small amount of common stock. In some cases, denial of voting power to one class of common stock is the only difference between the two classes. For example, the American Tobacco Co. has outstanding common stock and common stock B. The latter class is nearly twice as large as the former. Both are exactly alike except that the common stock only possesses voting rights.

Of course this kind of distinction could not be made by corporate directors unless there were people of some means able and willing to buy the nonvoting stock. Some of them are not interested in voting rights. In some instances, also, the purchasers of such stock were willing to forego voting rights in order to obtain the greater relative security that is frequently given to nonvoting stock. Perhaps also, among other reasons for the growing use of classified common stock in the decade of the 1920's, was the style element in security issues. Security salesmen like to have something new to talk about. This was a new idea that helped to sell common stock to people who hesitated to assume all the risks that are supposed to be attached to the residual claimant to the earnings and the assets of the corporation. Classified common stock provided, in a new form, the appeal that is offered to the speculative investor in a variety of guises.

The decline in popularity of classified common stocks can be accounted for on several grounds. In the first place, the issuance of all kinds of stock was at a low ebb during the 1930's and early 1940's. This naturally applies

to classified common as well as to other classes. It is probable that the novelty of the new kind of stock—new to American experience—has worn off. Even with a recurrence of new stock issues, it is likely that the better understood name of preferred will be restored to greater use, eliminating the need for classified common. Finally, various agencies of the government, having an interest in and an influence over the issuance of stock, do not look with favor upon the use of nonvoting stock. Since the absence of voting power is one of the distinguishing features of classified common stock, this governmental disapproval will probably interfere with future issues.

**Subordination Agreement.**—Occasionally a part of a stock issue is given temporary preference over the remainder of the issue, particularly with respect to the distribution of income. By a waiver of dividend rights for a specified time or until stated contingencies develop, one part of an issue may give preferential standing to the other part. A portion of the no-par preferred stock of the American Gas and Electric Co., when originally issued, was stamped to indicate that it was to be denied dividends from 1925 to 1927. Thereafter it became like the other preferred stock. In 1935, a subordination agreement was entered into by the O'Sullivan Rubber Co., Inc., and a number of its common stockholders, by which the latter agreed to waive their dividends until \$0.10 per share has been paid on other outstanding shares. Thereafter both the subordinated shares and the regular shares are treated alike. Subordinated shares can be restored to their original status only by a vote of the holders of the majority of unsubordinated shares. In 1936, the Segal Lock and Hardware Co., Inc., credited to its capital surplus \$100,000 representing cash received by the company in payment for the elimination of a subordination agreement waiving regular dividend participation on a part of its shares.

#### IV. MISCELLANEOUS STOCK ISSUES

In addition to classified preferred- and common-stock issues, there are a variety of types of stocks that contain one or more elements of preference, in comparison with other classes of stock. A brief description of the more common types follows:

**Debenture Stock.**—Debenture stock is a term borrowed from English practice. Its use in this country has been particularly unfortunate because we have long used the term "debenture" to describe a kind of bond. Indeed, in English experience debenture stock is a misnomer since it is really a bond as used there. Nevertheless, Americans have had a few notable instances of the use of debenture stock that was intended to be stock. When General Motors Corp. made use of two classes of debenture stock, it really issued preferred stock under a new and strange name. The resulting confusion led the corporation eventually to dispose of both of these issues and to simplify its corporate structure by using one class of preferred stock instead.

E. I. du Pont de Nemours and Co. also experimented with nonvoting debenture stock. Debenture stock of the Dennison Manufacturing Co. acquires voting rights after 1936 whenever over periods of 12, 24, 36, and 48 months its dividends average, respectively, less than 4, 6, 7, or 8 per cent. This stock is entitled to cumulative dividends of 8 per cent per annum, \$125 per share in case of liquidation of the corporation, and \$160 per share should the corporation exercise its right of redemption of this class of stock. The experiments with the use of debenture stock in this country, where the term has been used as synonymous with preferred stock, were not numerous. The results have not been such as to recommend extension of the practice.

**Prior-lien Stock.**—As the name implies, prior-lien stock possesses a claim prior to other outstanding issues of stock. It attains this status only by the consent of the holders of other classes of stock. This permission is given only under coercion. In times of financial crisis in the affairs of a corporation, when it is desirable to place a new issue of stock in a superior position, in relation to all other issues, such permission is requested and is usually granted. The purpose of the prior-lien stock may be either to raise new money or to exchange the stock for an issue of bonds whose claims to fixed charges have seriously embarrassed the corporation. In either event, other stockholders grant the right of priority reluctantly but nevertheless recognize the expediency of the request.

**Guaranteed Stock.**—In some quarters there is an erroneous conception that a corporation can guarantee dividends on its own stock and that, as a consequence, dividends on preferred stock are frequently “guaranteed.” As previously defined in American experience, a preference is never a guarantee. There are, however, various issues of guaranteed stock outstanding. Some represent very high-grade investments. When one corporation leases the property of another, the rental is sometimes stated in terms of a guarantee of an agreed dividend on the stock of the lessor company. Perhaps interest on the lessor’s bonds is assumed also. But the guarantee of the dividends makes the stock guaranteed. This places the payment of such dividends ahead of the payment of dividends upon any class of stock issued by the lessee corporation. Indeed it makes of the guaranteed stock a form of bond. Further discussion will therefore be found in the chapter on unsecured bonds. Either preferred or common stock may be guaranteed by a lessee corporation.

**“Special” Stock.**—Under unusual circumstances, corporations may issue stock that does not fit the usual classifications. Some such issues are designated in a manner to indicate their peculiar character. When the Plant (Thomas G.) Corp. was organized in 1927 to succeed the Thomas G. Plant Co., first preferred stockholders who purchased debentures of the new company were given, with each \$500 debenture, 6 shares of no-par “special” stock, 26 shares of second preferred stock, and 53 shares of common stock. “Special” stock has preference to noncumulative dividends up to 35 per cent

of the company's net income. It is entitled to a preference of \$1 per share and no more in case of liquidation. It is redeemable as a whole at the option of the company at \$10 per share plus dividends after 1937. It is also redeemable at the request of 10 per cent of the holders of first preferred stock. The common shares of Eastern Utilities Associates, a Massachusetts trust, have preference over convertible shares up to \$2 noncumulative dividends; receive twice the amount of dividends paid on convertible shares after the latter have received \$1 per share; and are entitled to twice the amount received per convertible share in case of liquidation. Convertible shares are convertible into common at the ratio of 2 for 1 when net earnings for 2 successive years have been not less than \$2.40 per share on the common and \$1.20 per share on the convertible stock.

**Blank Stock.**—Among the devices to give boards of directors great flexibility in the manipulation of corporate financial plans is the authority to issue blank stock. Authorized but unissued stock is created, to be issued at the discretion of the directors, with such dividend rates, priority of claims against assets in case of dissolution, and voting powers as they deem expedient. The actual issuance of such stock may change existing rights of already outstanding stock. It is probable that in its issuance controlling rights will not be overlooked by the directors.<sup>1</sup>

The Delaware charter of the United Corp., formed in 1929, provides: "Shares of capital stock of the corporation without nominal or par value of any class or classes, may be issued by this corporation from time to time for such consideration as may be fixed from time to time by the board of directors." In the early part of 1937, the stockholders of the Texas Gulf Producing Co. approved an amendment to the corporation's charter to provide for the issuance, at the discretion of the directors, of 50,000 shares of no-par preferred stock. The directors were given blanket authority to issue this stock in one or more series, with such dividend and liquidation rights, conversion privileges, and other terms and restrictions as the directors might see fit to apply to any series.

The prior preference stock of the Beneficial Industrial Loan Corp. is issuable in series, each with such designations, voting rights, preferences, and participating, optional, and other special rights as shall be determined by the board of directors at the time of issuance. The rights, privileges, and limitations of preferred and common stocks are subject to those of prior preference stock as and when issued.

In 1937, the Monsanto Chemical Co. asked its stockholders to authorize a sufficient amount of both preferred and common stocks to meet its needs for a considerable time in the future. The stockholders were requested to define the preferred in general terms only, thus permitting the board of

<sup>1</sup> Berle, A. A., Jr., *Corporate Devices for Diluting Stock Participation*, *Columbia Law Review*, December, 1931, pp. 1239-1265.

directors to issue and sell it in blocks or in series and to fix terms from time to time to meet current market conditions, such as dividend rates and call and liquidation prices.

The excuse commonly offered by boards of directors, in seeking permission from the stockholders to fix the terms of future stock issues, is the question of timing. The requirements of the Securities and Exchange Commission in approving the issuance of new stock, added to the uncertainties of the money market, are used as reasons for the request. The amount of time that the commission may consume in inspecting papers submitted in defense of a stock issue is somewhat unpredictable. Meantime the money market may change its character in a very short time. At the time an application is made to the commission for approval, money-market conditions may appear quite favorable to the success of the issue. Thirty days or even two weeks later conditions may have changed materially, because of the generally unsettled state of world economics. If further delays are encountered, due to the necessity for calling a meeting of stockholders to approve a specific stock issue, the favorable market may have been missed completely. By getting advance approval of the stockholders, at least that element of delay can be avoided. This is the line of reasoning followed by those who favor the issuance of blank stock.

#### IV. STATUS OF PREFERRED STOCK

**Summary.**—As pointed out in this and the preceding chapter, preferred stock is a kind of hybrid security that partakes of some of the features of bonds and some of common stock. Since the tendency is to balance preferences given to preferred stock with limitations, most preferred stock is neither fish, fowl, nor good red herring. It possesses the income weaknesses of bonds, without their elements of safety; likewise, it shares much of the risk of common stock, without fully participating in the income distributions of prosperous years.

If preferred stock was not subject to securities that hold prior claims to income and to assets, the holder would be much better protected than if he must first wait to have bondholders and other prior claimants satisfied. Where preferred-stock contracts adequately safeguard the interests of the holders, the stock at least is protected against the issuance of bonds. Even here, however, it is not possible to safeguard the preferred stock against an accumulation of debts to trade creditors and even to banks. In no case may the preferred stock attain the status of bonds even though it may prevent the issuance of bonds by exercising its veto powers, if it has them. Where preferred stock lacks the safeguards discussed in the preceding chapter, it more nearly resembles common stock than bonds.

Furthermore, if the preferred stock of a successful corporation is callable, it is quite probable that the board of directors will take advantage of a

favorable money market to redeem it, replacing it with stock paying a lower dividend rate. Since the directors customarily represent the interests of common stockholders rather than preferred, it is natural for them to think first in terms of the interests they most directly represent. Lower dividends to preferred stockholders pave the way for earlier and larger distributions to common stockholders. Even where the ranks of common stockholders are swelled by the admission of those whose preferred stock has been replaced by common, the original holders of common stock stand to gain, at least in the timing of dividend distributions. If prior claimants are eliminated, regardless of the size of their claims, earlier payments of common dividends are made possible.

Even where preferred stock carries the right of cumulating unpaid dividends, a favorable turn in the fortunes of the corporation may not be of immediate benefit to the preferred stockholders. As was pointed out earlier, the larger the accumulation, the less likelihood that it will be paid in cash. To be sure, this cumulation must be liquidated in some manner before any dividends can be paid on the common stock. But more often than not, the manner of liquidation provides little immediate cash for the preferred stockholders. The funding of dividend accumulations paves the way for the common stockholders to share almost as quickly as the preferred in better future earnings of the corporation.

There is no intent to imply that there are no sound investment opportunities in the purchase of preferred stocks. On the contrary, the prices of some preferred stocks vary less than the prices of many bonds. A review of the assumptions of Smith's "common-stock" theory of investment is pertinent at this point. Paraphrasing his "law" it would appear that (1) over a period of years, (2) a diversified list of preferred stocks, (3) issued by representative corporations, (4) in essential industries will probably justify their purchase at reasonable prices, provided that (a) the amount of prior claims is not too large in relation to the earning capacity and the assets of the corporations issuing them, and (b) the directors do not have the right to redeem the preferred stocks. To support this thesis, illustrations of price ranges of selected nonredeemable preferred stocks are cited in the table on page 155.

In the table, fractions have been omitted. The following additional information is of interest: Procter & Gamble has paid regular dividends on its 8 per cent preferred stock since it was issued in 1891. The lowest earnings per share during any year covered in the table was \$405.75. Eastman Kodak has paid regular 6 per cent dividends since 1902; lowest earnings in the above period, \$98.27 per share. National Biscuit has paid regular 7 per cent dividends since 1898; lowest earnings in the above period, \$40.26 per share. Union Pacific has paid regular 4 per cent dividends since 1900; lowest earnings in above period, \$18.62 per share.

## PRICE RANGES OF NONREDEEMABLE PREFERRED STOCKS

Year	Procter & Gamble Co.		Eastman Kodak Co.		National Biscuit Co.		Union Pacific Railroad Co.	
	High	Low	High	Low	High	Low	High	Low
1927	\$201	\$163	\$131	\$119	\$142	\$130	\$ 85	\$77
1928	200	170	132	123	150	137	87	82
1929	190	160	128	117	146	140	85	80
1930	175	160	134	120	152	142	88	82
1931	185	150	135	103	153	119	87	51
1932	150	140	125	104	142	101	71	40
1933	170	150	130	110	145	118	75	56
1934	195	161	147	120	148	131	89	71
1935	219	191	164	141	158	141	90	79
1936	220	208	156	152	164	153	100	98
1937	215	211	164	150	167	145	99	78
1938	217	211	173	157	168	150	83	59
1939	230	216	183	155	175	147	90	78
1940	235	224	180	155	176	155	89	70
1941	229	222	182	160	175	160	85	73
1942	230	227	180	170	166	140	81	74
1943	228	225	184	173	176	162	97	79
1944	232	227	195	175	181	165	104	92
1945	248	234	200	185	195	181	109	100

Many bonds would be proud of their ability to display such records. All of which means that not all preferred stocks can be condemned out of hand. Neither can the prospective purchaser jump to the conclusion that the name "preferred," prefixed to a stock issue, automatically puts it in a class much to be desired as a high-class investment. In the cycle of security fashion changes, perhaps the future will pay less heed to hybrid securities that partake, at least in form, of both ownership and creditor characteristics. To the extent that investors attain financial maturity which will enable them better to protect their own interests, or conversely, to the extent that a benevolent government undertakes to protect them, the continued use of callable, nonvoting, poorly protected preferred stock seems doubtful.

## QUESTIONS AND SUGGESTIONS

1. What is the most common type of limitation placed upon preferred stock?
2. How do railroad preferred stocks differ from industrial preferred, and why?
3. List the kinds of voting rights that preferred stock may possess.
4. In what ways may an income preference also become a limitation?
5. How does a corporation accomplish the redemption of its preferred stock?
6. What is the base upon which sinking funds are calculated?
7. Does a sinking fund operate to the advantage or to the disadvantage of preferred stockholders? Explain.



8. What is meant by classified stock? Which kind is classified—common or preferred?

9. Illustrate the use of serial preferred stock.

10. What, in effect, happens when a corporation uses classified common stock?

11. What has been American experience with classified stocks?

12. What is a subordination agreement? When is it used? What are its effects?

13. Where is debenture stock most commonly used? What has been American experience with it? Why?

14. What is meant by guaranteed stock? Can a corporation guarantee its own stock? Explain.

15. What is blank stock, and why is it used?

16. In general, what is the investment status of preferred stock? What are the dangers of generalizing on this subject?

17. Under what conditions might a preferred stock resemble a bond issue? When might it resemble a common-stock issue?

18. What inferences do you draw from the stock-price table at the end of this chapter?

19. Some of the stocks in this table have experienced an earnings ratio of more than \$1,000 per share in specific years. Is this fact as significant as the minimum earnings shown in the text? Why?

20. Under what circumstances would callable nonvoting poorly protected preferred stock be attractive to purchasers?

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#### SUBJECTS FOR INVESTIGATION

1. From recent issues of the *Wall Street Journal* or the *Commercial and Financial Chronicle*, find illustrations of classified stock. From a study of the manuals, find the preferences and the limitations of each.

2. Find three corporations with both preferred and common stock outstanding and with the common stock selling at a higher price than the preferred. Account for the difference in price.

3. Find two preferred stocks selling at about the same price but having different dividend rates. Account for the price of each.

## CHAPTER IX

### SHARES WITHOUT PAR VALUE

**Meaning of Par.**—Par value suggests two different yet related meanings. Originally the capital stock of a corporation was considered the measure of the contributions of the stockholders to the productive plans of the enterprise. As such it was looked upon as the irreducible minimum of the corporation's assets in measuring its capacity to pay dividends. Such contributions have even been described in terms of creditor liability to stockholders. "There is a sense in which every shareholder is a creditor of the corporation to the extent of his contribution to the capital stock. . . . It is a liability which is postponed to every other liability, and no part of the capital can be lawfully returned to the stockholders until all debts are paid or provided for."<sup>1</sup> The par value of the stock held by any one stockholder was considered to be the measure of the corporation's irreducible "debt" to him. The aggregate par value of all stock was the amount of the corporation's liability to its stockholders which was assumed to be kept unimpaired for the protection of both creditors and stockholders.

The foregoing statement may be considered to be the legal definition of par. Over the years there has grown up also a psychological concept that has dominated the thinking of many security owners. The par label on a share of stock has commonly been looked upon as a price tag to indicate its value. To many people, who are unacquainted with accounting procedures and the principles of financial analysis, if a share of stock has a par of \$100 it is assumed to be worth \$100. If it sells for less, it is thought to be undervalued. If it sells for more, it is considered to be overvalued. This concept is a product of the widening of the market for securities among all classes of people without too much business experience or too much opportunity to understand the principles governing security valuations.

Historically, these two concepts were synonymous. The amount contributed by the stockholder, which went into the "capital fund" of the corporation measured, at least at that instant of time, the value of the share of stock that he received as evidence of his contribution. At the outset, the par value of stock was not formalized in the form of \$100 shares which became so common later. In some cases the par was \$200, in others \$400, etc. Indeed in some cases par was not emphasized in setting up a corporation whose shares were to be closely held. A contributed one-eighth of the

<sup>1</sup> *Hamlin v. Toledo, St. Louis and Kansas City R.R. Co.*, 78 Fed. 664, 671.

capital and received in return one-eighth of the stock. *B* became the owner of one-fourth of the stock by the same process. If the corporation needed additional capital later, each contributed his share without reference to any formal par value. In some of the early corporations, such additional contributions were not accompanied by the issuance of additional shares of stock. The corporate charter sometimes provided for a fixed number of shares of stock whose par value was not to exceed a specified sum.<sup>1</sup> But as it became desirable to interest outsiders, it was necessary to indicate in some manner the value of the shares offered for sale. Hence par took on the significance of a price tag

**Price Labels on Shares.**—On the theory that a lower price attracts a larger number of buyers, nominal price labels on shares have declined steadily throughout the years. According to an English observer, in 1825 the favorite nominal value of shares in English companies was £100; a quarter of a century later this had been reduced to £10; by 1900, to £1; by 1910, to 2s; and by 1928, to 1s.<sup>2</sup> American experience shows comparable reductions: from \$1,000 per share in some cases a century ago; to \$100 (still common); to \$1 or a few cents or even 1 cent in a large number of cases in recent years. The par value of the preferred stock of the New Jersey Worsted Mills was \$1,000 per share until the articles of incorporation were amended in 1922, changing it to \$100.

**Difficulties with Par Value.**—Because of the legal restrictions placed upon the use of par stock, requiring that the par value be contributed by the stockholder to the corporation in money or its equivalent to relieve the stockholder from further liability, the abandonment of the use of par stock was inevitable. In spite of the presumption of equivalent stockholder contributions whenever full-paid and nonassessable stock was issued, common practice determined the frequent use of overvalued stock. Only the absence of enforcement machinery protected the stockholders against the payment of added assessments, whenever such corporations faced financial difficulties of a character that jeopardized the position of their creditors. The common exchange of stock for overvalued property and the equally common distribution of bonus shares with the sale of bonds or prior issues of stock, offset on the balance sheet with questionable intangible assets, always left doubt about what might happen if some alert creditor took legal steps to protect his own interests. The answer seemed to lie in the issuance of stock without par value and hence without additional liability to its owners. Furthermore, the psychological concept of par stock resulted in loss to purchasers who took the par label seriously and used it to measure the value of the stock.

**Intent of No-Par Stock.**—Because of the difficulties involved in the attempt to prevent deception accompanying the sale of par stock, the past

<sup>1</sup> Angell and Ames, *op. cit.*, p. 307.

<sup>2</sup> Brown, Oswald M., "The Routine of a Public Issue" (Cambridge, 1932), p. 5.

thirty years have witnessed a flood of laws whose purpose has been to put the would-be stockholder on notice that the stock offered him has no dollar mark and that he must determine its value for himself. The theory underlying such laws is fundamental to an understanding of the meaning of a share of stock, *viz.*, that, in the absence of preferences and limitations, a share of stock represents a proportional interest in the residual ownership of a corporation—a right to participate in management and to share in the earnings distributed and in the assets in case of dissolution. Such laws strip stock certificates of their deceptive price tags and leave the share of stock merely as evidence of participation in ownership. The law does not attempt to define the value of the participation certificate. It denies the right of the certificate to carry evidence of its own value. It serves notice that valuation is a difficult process, resulting in changes from day to day, to be determined at any particular time by the use of information which, in the very nature of the case, cannot be carried on the face of the certificate itself.

**No-Par Stock Laws.**—The first no-par law was passed in New York in 1912. Most of the other states have since followed New York's example. Experience under these laws has justified neither the hopes of their proponents nor the fears of their critics. Some legislation has included absurd provisions that have aborted beneficial results that might have followed the elimination of the par price tag. Some provisions of revenue laws have unduly penalized the use of no-par stock and encouraged corporations to change back to par carrying low par labels.

**Advantages Claimed for No-Par Stock.**—One man's meat is another man's poison in the use of no-par stock. A fraudulent promoter might secure an advantage by acts that would work to the disadvantage of those who bought his worthless stock. In the discussion that follows, this dual conception of advantage and disadvantage must be kept in mind. As far as possible, the advantages and disadvantages will be considered from the viewpoint of the larger interests of the corporation as a whole and not from the standpoint of any selfish group. Such advantages claimed for no-par stock include the following:

1. *Flexibility.*—The stock is sold at the price that will attract purchasers. The price received by the corporation reflects the market's estimate of the value of its stock. One block may be sold at a low price when the corporation is young, inexperienced, and unknown. Later successes may make possible subsequent issues at higher prices. At any rate, so long as the market imputes any value at all to the corporation's stock, it can be used for the purpose of raising capital as and when needed.

2. *Full-paid and Nonassessable.*—In the absence of fraud, no-par stock carries no liability other than the price received for it, provided that this is as much as its stated value, which is usually the case. No subterfuge of issuing stock for overvalued property or services, the donation of a portion

thereof to the corporation, and its subsequent sale as treasury stock is necessary. The amount received for it, be it large or small, provided that it is as much as the stated value, fulfills the obligations of its purchaser to the corporation.

3. *Truthfulness.*—No-par stock can be carried on the books at the amount paid for it. There is no need for inflation of assets to offset inflated stock issues. Where par stock is used, the equities side of the balance sheet is made up first, and then assets are valued to balance equities, frequently by the use of inflation. No-par stock makes possible the entering of assets at their true values and offsetting the same with equivalent equity entries.

4. *Investors Warned.*—The psychology of par value is misleading. It centers attention upon the price tag on the stock. When no-par stock removes this, the investor is asked to center his attention upon assets and earnings—the more reliable bases of value.

5. *Reorganizations and Consolidations Facilitated.*—Consolidations and reorganizations frequently necessitate reduction in fixed and contingent charges and elimination of deficits or unwieldy good-will accounts. The substitution of no-par stock for par under such circumstances facilitates the gaining of the ends sought. Stated capital may be reduced painlessly. Stockholders who might otherwise object to a nominal scaling down of their holdings can be given the same number of shares that they had before. Since the no-par stock carries no price tag, the stockholders are not so likely to investigate the effects of the change upon balance-sheet entries.

6. *Bonus Stock.*—Where the use of bonus stock seems desirable, it can be effected readily with no-par stock. The subterfuge of treasury stock is made unnecessary if bonus stock carries the no-par label, since the total amount issued can be carried on the books at such a nominal amount that it presents no legal obstacles with respect to possible future liability.

7. *Wider Distribution.*—No-par stock is usually issued at lower prices than par stock. Subsequent prices can be kept down by liberal distributions of stock dividends. These low prices attract a larger number of small security purchasers, thereby attracting more capital without endangering present control of the corporation.

8. *Intangibles.*—Without fear of misrepresentation, no-par stock may be issued in payment for intangible assets and for properties not large in inventory values but valuable when measured by earning power.

9. *Increased Marketability.*—When it is desirable to reduce the market value of stock, this may be readily accomplished by issuing a larger number of shares in exchange for those outstanding, or by declaring a dividend in no-par stock without disturbing surplus, merely dividing the capital account into a larger number of shares.

10. *Accounting Simplified.*—Through the use of no-par stock, a corporation may dispense with attempts to conceal stock discounts and underwriting

and financing costs and thereby eliminate entries for organization expense and deferred charges. There are usually no stock discounts. Underwriting expenses and financing costs can be absorbed at the time the stock is sold, by deduction from the proceeds of the sale.

11. *Donated Stock*.—With no-par stock, it is no longer necessary for those who exchange property or services for stock to donate to the corporation a part of their holdings to be sold for the purpose of securing working capital. Working capital may be secured through the direct issue of no-par stock by the corporation at whatever price purchasers will pay for it.

**Doubtful Advantages.**—Among the advantages claimed for no-par stock are some of questionable significance, when the larger interests of the corporation and its constituent parts are considered. Some of these advantages are classed as doubtful because of the confusion that surrounds them, and some because of the selfish interests served by them. In this group should be included the following:

1. *The Fiction of Stated Value*.—Two theories are used as the basis for the capital-stock account in the balance sheet. One assumes that this item is to be credited with the capital contributions of the stockholders—that the account represents the aggregate of the prices received for all stock issued. From this point of view, capital is usually thought of as the amount contributed by the stockholders. This is held to be synonymous with the limit of liability of stockholders to the creditors or with the stated value on which the creditors rely. The other assumes that this account is entirely a tool of boards of directors who may credit it with much or little as they see fit. Stated capital, according to this assumption, is not the amount of capital available to the corporation but any fictitious amount “stated” by the board of directors. Under the laws of many states, boards of directors may divide the price received for stock into two or more parts: one, usually a nominal amount, to be credited to “stated” capital; the remainder to be credited to capital surplus, paid-in surplus, or just surplus.

No-par stock laws vary greatly in dealing with this subject. A few require that the entire consideration received from the sale of no-par stock shall be considered as capital. At the other end of the line, a few statutes merely require that the corporation shall state the number of no-par shares it has issued; but apparently no part of the consideration received therefor need be carried to the capital account. New York laws provide that either all the proceeds from the sale of no-par stock or at least \$1 per share shall be recorded as capital. New Jersey leaves the amount to the discretion of the directors. The majority of state laws provide that all the consideration from the sale of no-par stock shall be included in the capital account, unless some part thereof is allocated by the board of directors to a surplus account.

With the way opened by such laws, boards of directors follow a variety of practices. The proceeds of the sale of stock are not always divided

between stated value and surplus. In the case of the Central Investors' Corp., the proceeds from the sale of 50,000 shares of capital stock were divided as follows: (1) \$.50 per share to the capital account, (2) an amount equal to the earnings per share since the latest dividend disbursement to the distribution account, and (3) the remainder to paid-in surplus. In effect, the purchaser not only contributed to the surplus (3) but to the dividend account (2) as well. Perhaps the latter should be called paid-in dividend. At any rate, when the purchaser received his first dividend, it would include at least a part of what he has paid in.

The use of stated value is not only confusing to anyone wishing to analyze the balance sheet of the corporation, but it is distinctly unfair to the creditors who look to the "capital" of the corporation for their protection. Furthermore, it tends to nullify the entire truthful intent of no-par stock laws. In effect, stated values do not create no-par stocks: they create low-par stocks. Cook says in this connection, "no par value leads to no capital—a corporation without a *corpus*."

One wonders whether Cook's statement is to be taken literally until he starts to look for the accounting results of no-par stock laws. It is not uncommon to find a variety of corporations carrying their stock at a nominal amount of a few hundred dollars or less. For example, Ward Baking Corp. carries 500,000 shares of Class B common stock at an aggregate value of only \$100. The Sunset Oil Co. was authorized to issue up to 530,858,484 shares under its reorganization program. It planned to carry all its stock, regardless of the number of shares outstanding, at a total of \$70.

Taking advantage of those laws which permit corporation directors to decide what part of the proceeds of the sale of their no-par stock shall be allocated to their capital accounts, some corporations let \$1 represent their total capital. All else is carried to some surplus account or accounts. Among the corporations whose aggregate stated value of all common stocks is \$1 are the following:

Name of Company	Number of Shares of No-par Stock
Calorizing Co. ....	62,500
Colorado Construction Corp. ....	7,600
Consolidated Steel Corp., Ltd. ....	241,617
Darco Corp. ....	12,907
Dictaphone Corp. ....	127,685
General Alloys Co. ....	233,613
National Automotive Fibres, Inc. ....	50,000
Union Compress and Warehouse Co. ....	23,827
United Brick Corp. ....	93,786

Still other corporations, organized in states which require only that the number of no-par shares shall be recorded, have reduced their aggregate capital, as shown by their balance sheets, to the irreducible minimum of

"nil." Among the corporations that have followed this practice are the following:

Name of company	Number of shares of no-par stock	Aggregate stated value
Bausch Machine Tool Co. ....	75,000	Nil
Imperial Royalties Co.* .....	1,804,052 common	Nil
Imperial Royalties Co. ....	91,456 Class A	Nil
Kansas City Structural Steel Co. ....	7,500	Nil
Metropolitan Playhouses, Inc. ....	49,842 8	Nil

\* Deficit at end of 1935, \$8,229,422; total assets, less than \$800,000.

Nor is the situation remedied by the absence in the law of any stated value. In such case, the board of directors may determine the amount to be credited to the capital-stock account, unhampered by any legal minimums. In effect, the results are usually the same, since legal stated values are usually nominal. The remedy lies in the use of common sense—in requiring that the price received for no-par stock shall always be credited, *in toto*, to the capital-stock account. By this means, confusion is avoided, truthfulness is served, and the creditors have the full protection of the stockholders' capital contributions.

2. *Legal Capital*.—Various attempts have been made to define the legal status of stated capital and indeed to arrive at a concept of legal capital. One such effort bases its arguments upon the assumption that, as a condition for granting to stockholders the privilege of operating in a corporate capacity with limited liability, the subscribers for shares are required to invest certain amounts in the business. Hence that part of the consideration for the shares which measures the contributions to the capital of the corporation represents legal capital. Its functions are threefold: (1) to protect creditors against stockholders, (2) to protect senior stockholders against the holders of junior shares, and (3) to protect all stockholders against mismanagement and impairment of their investment and its earning power.<sup>1</sup>

3. *Legal Capital Stock*.—In attempting to overcome the deficiencies in existing statutes on the subject of what properly constitutes capital stock, the Uniform Business Corporation Code recommends the following language:

The "capital stock" of a corporation at any time is the aggregate amount of par value of all allotted shares having par value, including such shares allotted as stock dividends, and the aggregate of cash and the value of any consideration other than cash, determined as provided in this Act, agreed to be given or rendered as payment for all allotted shares having no-par value, plus such amounts as may have been transferred from surplus upon allotment of stock dividends in shares having no-par value.

<sup>1</sup>Ballantine, H. W., and G. S. Hill, *Corporate Capital and Restrictions upon Dividends*, *Accounting Review*, September, 1935, pp. 246-268.



The general adoption and common application of this definition would go a long way toward the solution of many troublesome corporate problems.

4. *Basis for Preferred Stock.*—The laws of some states prohibit the issue of preferred stock beyond a fixed proportion to the number of common shares outstanding. By the use of no-par stock with a low unit value, the above provision may be evaded. Presumably, the purpose of the law is to protect the investment of the preferred stockholder who contributes the real capital to the corporation. Evasion of such intent by the use of no-par stock hardly seems fair to the holders of preferred stock.

5. *Valuation of Properties.*—It is contended that the use of no-par stock simplifies the valuation of properties exchanged for such stock in the organization of the business. Should the corporation never issue more than one block of stock exchanged for a single property and should it not be required to account for such a transaction, this contention might be justified. Accounting requirements alone would necessitate the valuation of the property received by the corporation. But more important is the fact that such property must be evaluated carefully in order to determine the fair value of shares issued in exchange for it. Additional issues of stock must be at prices that shall be equitable to the existing stockholders. The real advantage of no-par shares in relation to valuation proceedings lies in the fact that such shares can be issued full-paid and nonassessable.

6. *Manipulation of Surplus.*—By a change of par stock to no-par stock, a surplus can be created through the transfer of credit from the capital-stock account. This surplus can be used to absorb an operating deficit or to write down an unwieldy good-will account. It may even form the basis for cash-dividend distributions. Such practices conform to neither good morals nor sound business judgment. They are even of doubtful legality in most jurisdictions, if intelligent creditors, or other interested parties, appeal to equity courts for protection. Sometimes even par stock is treated as if it were no-par. In spite of the fact that the common stock of the Zeigler Coal and Coke Co. has a par value of \$10 per share, the company reported its common stock for its net worth. By this means, it was able to eliminate a very sizable deficit.

**Disadvantages of No-par Stock.**—The disadvantages in the use of no-par stock are due, in part, to the nature of the concept itself; in part, to the relative newness of the idea; and, in part, to the abuses commonly accompanying its use. The more common disadvantages include the following:

1. *Market Hindrances.*

a. Par value still possesses a psychological advantage in the security markets. There are still security purchasers looking for markdown bargains. The stock without a price tag does not appeal to this group.

b. "One price for all" causes some security purchasers to hesitate to pay for stock today a price that may be changed by the corporation tomorrow.

Such purchasers overlook the fact that the market evaluates even par stock differently from day to day.

c. *Modesty and headaches hinder the sale of no-par stock.* Some security purchasers recognize their own limitations in attempting to evaluate shares of stock. Others hesitate to undertake the study necessary to arrive at a conclusion. In the absence of reliable and trusted counsel, both of these groups are apt to place some reliance upon the price-tag stock in preference to no-par stock.

2. *Cloudy Statutes.*—Lack of uniformity and of clarity in no-par statutes leads to confusion and deception in the use of no-par stocks by the inexperienced and the unscrupulous. Some laws invite accounting practices that make impossible any separation of so-called stockholders' equity into its elements. Capital contributions, earned surplus or operating deficit, and surplus resulting from unrealized revaluation of assets are frequently so confused that the true condition of the financial affairs of the corporation is fully concealed. The use of no-par stock aggravates this condition where the statutes are not clear in their requirements.

3. *Taxation.*—Because of the long history of \$100-par shares, the tendency has been for tax laws to assume that no-par stock is equivalent to \$100-par shares. Since most no-par stock has been issued at much less than that amount, the result is a tax discrimination against no-par stock. To counteract this disadvantage, it is not an uncommon practice for corporations to issue no-par stock and carry a fraction of the sale price as stated capital, say \$1 per share, crediting the remainder to paid-in surplus, capital surplus, etc. Thereafter, the tax burden may be relieved considerably by changing the no-par stock into par stock with a \$1-par label. In 1936, the Eaton Manufacturing Co. changed its stock from a stated value of \$4 per share, no par, to \$4-par value. No change was made in the balance sheet, but the stockholders were given the advantage of reduced transfer fees.

4. *Weakening of Credit.*—Where the proportion of the proceeds from the sale of no-par stock that is credited to stated capital is small, the corporation may find the amount of credit extended to it restricted. The rights of creditors against holders of no-par stock are usually meager and hard to enforce. Unpaid or underpaid stock is less common where no-par stock is used. Because of the confusion described above, creditors may not readily determine their protection from the balance sheets of corporations with no-par stock.

5. *Accounting Difficulties.*—Inexperienced or unscrupulous boards of directors may make the work of their accountants not only difficult but impossible, if accounting statements are expected to reflect the true condition of the corporation's finances. No-par stock encourages falsification of accounts.

6. *Stock Dividends*.—The clamor of disgruntled stockholders may be quieted by boards of directors through the declaration of no-par stock dividends which affect neither assets nor surplus but merely divide the capital account into a larger number of shares. This may work to the disadvantage of the deceived stockholders.

7. *Misleading Impressions*.—Much of the discussion surrounding the substitution of no-par stock for that bearing a price tag has carried the implication that the mere removal of the price tag has made stock swindles impossible. Many stockholders have been given a false sense of security in the purchase of no-par stock. The protection that no-par stock may give is not automatic. The purchaser is merely put on notice that the price tag is deceptive and that the measure of value of the stock must be sought elsewhere. The seeking process requires the active interest of the purchaser. Passivity is not rewarded by no-par stock.

8. *Unwarranted Dividends*.—Misguided boards of directors, who remember that their corporation has a sizable surplus but forget that the sale of no-par stock created it, are apt to declare dividends under the misapprehension that they are distributing accumulated earnings.

9. *Legal Complications*.—While no-par stock laws have liberalized and extended the powers of boards of directors in controlling the finances of corporations, they have not completely opened the floodgates to every whim that a board might wish to gratify. Inexperienced and poorly advised boards may be misled into decisions that they would find difficult to justify before the law, should their actions be questioned in court proceedings. Their protection lies in the infrequency with which creditors and stockholders exercise their right to appeal to the courts.

**No-par Preferred Stock**.—As already indicated, preferred stock does not usually have voting rights. Its preferences most often relate to prior claims against earnings and against assets in case of dissolution. Where par stock is used, the price tag usually affords the measure of preference against assets. True no-par preferred stock, therefore, would seem to be inconceivable since it would give such stock no preference against assets. The riddle was solved by giving no-par preferred stock redemption value and using this as the measure of preference against assets. This device makes possible the paradoxical somersault of having preferred stock without par value until it is sold and thereafter making it par stock.

**Accounting Difficulties**.—Such a procedure creates accounting difficulties that are met by various means. Suppose, for instance, no-par preferred stock is sold at \$40 per share but is redeemable at \$50 and has prior claim against assets up to \$50. How shall these conditions be shown on the balance sheet? Clearly the capital contributed is only \$40 per share. Yet one could hardly say that the common stock has undisputed claim to all of surplus, if no appropriation is made for possible redemption or liquidation

of preferred stock. The balance sheet should contain at least parenthetical information setting forth all pertinent facts in the case.

**Credits to Capital Account.**—Where combinations of par preferred stock and common stock (with or without par) are sold as units, problems frequently arise from the difficulty of apportioning proper credit to the common-stock account. Preferred stock presents no problem, since its par value measures the credit to the preferred-stock account. But where units of no-par preferred and no-par common are sold, further complications arise. How shall the price of the unit be divided between the two accounts?

**Stated Value Again.**—In Delaware, at least, a corporation could answer this question in various ways, none of which may be satisfactory to the seeker after truth. One curious answer would be to permit the corporation to credit to each stated capital account a nominal amount and to allocate to capital surplus for each class of stock such amount as the board of directors sees fit. The final result of such action might be to pay cash dividends on common stock from the proceeds of the sale of the preferred stock.

**Position of No-Par Preferred Stock.**—Serious questions are being raised about the investment status of preferred stock with par value. Additional complications arising from the use of no-par preferred stock warrant the conclusion that the removal of the par label from preferred stock has not been justified by experience to date.

Even preferred stockholders become the victims of expediency at times. No-par stock finds useful tasks in many tight situations. The directors of the Pennsylvania Dixie Cement Co. suggested to its stockholders that its \$100-par-value preferred stock be exchanged for series A no-par convertible \$7 cumulative preferred stock. This would permit a write-down of the preferred stock from \$12,120,000 to \$3,030,000, the difference to be allocated to paid-in surplus. Thereafter \$9,399,308 of paid-in surplus would be placed in a special reserve, against which would be charged annually that portion of depreciation and depletion not allowed for Federal income tax purposes. The proposal leaves a number of interesting questions unanswered.

### QUESTIONS AND SUGGESTIONS

1. Is a stockholder ever a creditor of a corporation?
2. Contrast the legal with the psychological concept of par.
3. What was the attitude of America's earliest corporations toward the concept of par value?
4. When did the par label become significant?
5. Over the years, what has been the tendency in stating the amount of par labels on stock? Why?
6. What was the outstanding reason for the introduction of no-par stock?
7. What is the intent of no-par stock?
8. By what process did corporations acquire the right to issue no-par stock?

9. What are the chief advantages claimed for no-par stock?
10. Explain what is meant by the fiction of stated value. Why is it called a fiction?
11. If stated value were not used, would the quotation from Cook in the text be true?
12. How would you justify the practice of carrying all stock on the balance sheet at a nominal sum of \$1? Or at nothing at all?
13. Define legal capital, and state its functions.
14. How may the use of no-par stock facilitate the manipulation of surplus? Give examples.
15. What are the disadvantages in the use of no-par stock? Which are likely to decrease in importance with the passage of time? Why?
16. Does the use of no-par preferred stock present any peculiar problems? Explain.
17. Can you justify the practice of the state of Delaware in dealing with the subject of no-par stock? Explain.
18. What is the current practice with the use of no-par stock in railroad reorganizations? How do you account for it?

### SUPPLEMENTARY READINGS

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- DONALDSON, E. F.: "Business Organization and Procedure" (New York: McGraw-Hill Book Company, Inc., 1938), Chap. XXV.
- LINCOLN, E. E.: "Applied Business Finance" (McGraw-Hill Book Company, Inc., 1941), Chap. V.
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### SUBJECTS FOR INVESTIGATION

1. From a recent issue of the *Commercial and Financial Chronicle* or other available source, find the proportion of common stocks of industrial corporations that are listed as no-par. Make the same comparison for preferred stocks.
2. Compare the stated value (or par), the book value, and the current market price of the common stocks of each of the following corporations: American Tobacco, Briggs Manufacturing, Chrysler Corp., Du Pont, General Electric, General Motors, and Johns Manville.
3. Find from current manuals three corporations that carry their common stock at only nominal value. See if you can account for these practices in the specific cases chosen by you.

## CHAPTER X

### CORPORATE INDEBTEDNESS

**Corporate Capital.**—In the preceding chapters, capital contributions by stockholders have been discussed. In the financing of American corporations, much capital is received from other sources, including trade creditors and individual and institutional lenders. Borrowed capital from the latter source is usually evidenced in the form of bonds and notes. Bondholders are usually distinguished from stockholders by designating the former as creditors of the corporation and the latter as owners. In many cases, the bondholders may be the real owners, while the stockholders are merely residual owners. It would be very difficult to array the contributors to the capital of a corporation, with the best protected prior-lien bondholders at the top and the most common garden variety of common stockholders at the foot, and then divide them into two groups, one of which we would designate unequivocally as bondholders and the other as stockholders. The two groups may have more likenesses than differences. They shade into each other in such manner as to make distinctions difficult to sustain.

**Why Corporations Borrow.**—On the side of demand, corporations borrow whenever they think they can obtain an advantage thereby. Many American corporations find use for more capital than their stockholders' contributions, supplemented by their own earnings. Then, too, borrowing is economical. Many capitalists are willing to accept a lower rate of return than that expected by stockholders, provided they can minimize their risk. In other words, the supply of funds available to a corporation is often such that it can borrow more cheaply than it can purchase capital.

**Supply of Funds.**—Capital is created at a prodigious rate. It seems, at times, that one might almost define a capitalistic society as one that creates more productive capital than it can always use effectively. The enormous investable surplus of America is available to corporate borrowers, in the form either of individual savings or of huge aggregates in the coffers of savings banks, insurance companies, trusts, and other financial institutions. Idle funds are unproductive, so that, except for periods of tight money, prospective investors are always seeking outlets for their surpluses.

Some Americans are stock-minded, preferring to invest their surplus funds where their owners may enjoy the opportunities that come to those whose securities advance rapidly in favorable markets. Others, dominated by fear, custom, and inhibitions of one kind or another, hesitate to take too great

chances. Among these we find bond buyers rather than stock purchasers. In addition to individuals who buy bonds, legal restrictions keep many financial institutions out of the stock market and confine their purchases to bonds and mortgages.

**Trading on the Equity.**—Someone, with a capital of \$10,000 invested in a business that earned an annual profit of \$1,000, or 10 per cent, discovered that if he borrowed another \$10,000 at 5 per cent, and made \$2,000 on his total capital of \$20,000 he would have left, after paying \$500 interest on his borrowed money, \$1,500 profit. This was equivalent to 15 per cent on his own investment. By this experiment he discovered the principle of "trading on the equity." The principle assumes that the owner of the business starts with an equity that will serve as protection for the lender. With this equity present, the lender, in turn, is willing to advance a loan at a relatively low rate of interest, in comparison with expected returns upon stock. Borrowing may be used as a device to increase earnings on stock whenever the cost of the loan is less than the amount it earns for the borrower.

But trading on the equity has its hazards also—both for the borrower and for the lender. Suppose, for example, in the illustration given in the preceding paragraph, that the total earnings on the \$20,000 had been only \$500 instead of the assumed \$2,000. Then all the earnings would have been required to pay interest on the loan, leaving nothing to compensate the owner of the original capital. Or suppose that, instead of a gain, the operations of a given year merely met expenses, leaving neither gain nor loss. There would still be an interest charge of \$500 to be met by the borrower. It is in periods of "lean years" that trading on the equity becomes embarrassing for the management.

Nor is the presumed equity always sufficient to protect the interests of the lender. While the equity may appear ample at the time the loan is made, it may shrink even to the point of disappearance in times of adverse earnings. In general, railroads and public utilities make more common use of the principle of trading on the equity than do industrial corporations. Holders of railroad bonds have frequently learned, to their financial sorrow, that equities provided by stockholders may fade away in the face of declining profits in the railroad business. The competition of private automobiles, trucks, busses, and airplanes has interfered with the financial theories of those who depended upon the monopolistic character of a transportation agency to justify large bond issues. The presence of heavy investments in fixed assets is not a sufficient protection for bondholders. There must be, in addition, assurance of continued net earnings sufficient to meet all obligations to creditors.

**Significance.**—There is no intent to imply that all corporate borrowing is motivated by the desire to trade on the equity. Rather the evidence seems to confirm the impression that, in industrial corporations at least, trading

on the equity is not to be taken too seriously. A recent study on the subject arrives at the following conclusions:

Some companies can avoid borrowing because their earnings margins are sufficiently high to enable them to sell shares of stock satisfactorily when new capital is needed, or to satisfy needs by reinvestment of earnings. Others borrow because funds can be obtained more readily from creditors than from stockholders. In few cases, apparently, is the principle of trading on the equity studiously followed. . . . The conclusion is reached that industrial corporations base their financial policies on many considerations other than the safety or danger of becoming involved in debt. . . . When they do borrow, in many cases it is from necessity rather than from choice.<sup>1</sup>

**Leverage.**—In a sense trading on the equity and leverage may be used interchangeably. Both suggest means by which the owner of the share capital may increase his rate of earnings through the process of spreading his equity to cover bond issues or other borrowings. Leverage is perhaps more harsh in its implication, since it places the emphasis upon the spreading of the equity in thin layers. Trading on the equity tends to call attention to the fact that, after all, there is an equity to protect the lender and that its existence justifies the collection by the owner of the share capital of a return for its presence. In some respects, the word leverage is a more honest term because, in both cases, the owner of the share capital is trying to use it as a lever to lift a heavy load of borrowed capital, thereby earning for himself a larger return than if he relied only upon the use of the capital that he owns.

Sometimes a distinction is made between internal and external leverage. Trading on the equity is an example of the latter. Internal leverage occurs when a corporation accumulates earned surplus and proprietorship reserves that continue to earn for the corporation, but without obligation to pay anyone specifically for their use. For example, suppose a corporation had earning assets of \$1,000,000, represented by stock of \$750,000 and surplus and proprietorship reserves of \$250,000. If the corporation earned 6 per cent on its total investment, this would be equivalent to 8 per cent on its outstanding stock. This advantage is called "internal leverage."

**Limits on Borrowing.**—Since borrowing creates obligations to be liquidated in the future, only a reader of the future can tell whether or not such obligations can be met. Those who claim such power are not usually entrusted with the management of business corporations. It is probably true that more business tragedies result from overborrowing than otherwise. There are no hard and fast rules to prevent such errors. In general, a corporation should not borrow when it has no assurance of meeting interest payments currently and of providing for principal installments when due.

<sup>1</sup> Jamison, C. L., *Trading on the Equity by Industrial Companies*, *Michigan Business Studies*, Vol. VI, No. 3, pp. 230-231, 1934.



The rule-of-thumb practice is that earnings available for interest should always be twice as great as the interest requirements and that the property values of the corporation should always provide a cushion of safety over and above the amount of the loan.

**Forms of Borrowing.**—Corporate borrowing is usually classified into “short-term” and “long-term.” The former includes obligations that carry a promise of liquidation within 5 years. The latter run for 20 years or more. The relative amount of borrowing for 5 to 20 years is not large enough to cause this classification to be seriously questioned. The differences are not quantitative but qualitative. The character of the short-term loan differs materially from that of the long-term, irrespective of term. The purposes of issue, nature of obligations assumed, and kinds of contracts used help to differentiate one from the other. Intermediate borrowing will be discussed in a later chapter.

**Self-liquidation.**—It is frequently contended that short-term notes should be self-liquidating; *i.e.*, that the use of the proceeds therefrom should provide the means for their repayment when due. Self-liquidation is a noble thought—if not taken too seriously. Of course a short-time loan should pay its own way. But so should a long-time loan. If the proceeds of a bond issue running for 30 years are used to construct a building that will not pay for itself within that time, poor business judgment has been used. If a department store borrows \$1,000 to buy shoes that it sells for \$800, it has used poor business judgment. But one would hardly expect a department store to make such narrow use of the concept of self-liquidation as to keep the proceeds from the sale of the shoes, even at a satisfactory profit, in a separate compartment in the cash drawer in order that the loan might be specifically self-liquidating. The business should always be self-liquidating whether specific loans are or not.

**Uses of Short-term Notes.**—Short-term notes may be divided into two classes: commercial notes running from 30 to 90 days and discounted through commercial banks or sold through note brokers, and those more formal corporate notes carrying many of the characteristics of long-term bonds and running from 1 to 5 years. The discussion that follows deals with the latter. The conditions that invite their use include the following:

1. *Money Market.*—At the time the money is needed the condition of the money market may discourage attempts to secure capital by other means.

2. *Temporary Needs.*—The period for which the capital is needed may be short, yet longer than that usually served by bank loans.

3. *Early Retirement.*—If the earning power of the corporation is large, it may have reasonable expectation of retiring the notes from future earnings without employing other means of financing.

**Disadvantages in Use of Short-term Notes.**—Careful planning merely attempts to anticipate future happenings and provide for them. It cannot

always foresee the future accurately or be sure that the planned ~~and~~ will work or even be available. Certain disadvantages and dangers ~~and~~ always accompany the use of short-term notes. They include the following:

1. *Cost.*—Cost of financing, and particularly of refinancing, if that is necessary, by means of additional short-term notes, is generally quite high. All the investigation and sales expenses must be amortized over such a short period of time as to make the effective interest rate quite high in comparison with bond interest.

2. *Condition of Money Market.*—Short-term notes issued to avoid the penalties of tight money may mature when money is just as tight or tighter. The original obstacles to long-term financing are aggravated by the existence of obligations already incurred and now matured under unfavorable conditions.

3. *Acute Embarrassment.*—If the proceeds of the note issue have been invested in fixed assets that are not yet returning a profit, the maturity of the notes may find the corporation unable to meet the obligations from earnings and unable to refund the loan. Acute embarrassment, or even insolvency, may follow, in the face of a wealth of assets that would support a strong credit rating under other conditions.

**Bonds Defined.**—Bonds are promissory notes. In fact, a bond issue may be thought of as a series of notes of like character and like maturity. The mere mechanics of bond issues differentiate them sharply from ordinary promissory notes. The formalities surrounding the issuance of bonds require more careful prescription.

**Parties to Bond Issue.**—Omitting, at this time, any discussion of syndicates and sales organizations, the parties to a bond issue are as follows:

1. The corporation wishing to borrow the money.
2. The trustee through whom the corporation deals with the bondholder. Because there may be many bondholders, the corporation makes an agreement with the trustee or trust company which is variously called the "deed of trust," "trust agreement," "trust indenture," etc., setting forth the obligations assumed by the corporation and the rights to be acquired by the bondholders.

3. The bondholders who participate in the loan and who receive as evidence of their participation one or more bonds. The contract between the corporation and the bondholder consists of the bond and the deed of trust.

**The Deed of Trust.**—The original contract, binding the corporation to the bondholders, is a wordy legal document varying in size from fifty to several hundred printed pages, the existence and contents of which are known to but few bondholders. Seldom would any ask to read it. They do not read even the contents of the bond. Yet this deed of trust is the source of bondholders' rights and the corporation's obligations. In case of default, it must be consulted before action may be had against the corporation. It

may contain a clause giving the corporation a couple of years' grace in case of interest default.

**Contents.**—The usual deed of trust or indenture contains, in addition to the legal formalities of names of parties, authorization for the issuance of the bonds, etc., the following clauses:

1. The form of the bonds to be issued and of the coupons, if any.
2. In the case of a mortgage bond, the description of the pledged property. Since this must be for the purpose of legal identification in case of a default in the bonds, the details required may consume considerable space. Where collateral trust bonds are issued, a similar description of the collateral is employed.
3. Mortgagor covenants describe the specific obligations that are assumed by the borrower. These include such subjects as taxes, insurance, repairs, and restrictions upon additional indebtedness.
4. Provisions for retirement of the bonds, uses of sinking funds, and conditions under which parts or all of the pledged property may be released.
5. Default and its consequences. Default, for the purposes of the particular bond issue in question, is carefully defined. This definition includes the grace period during which the mortgagee has no right to take steps to enforce the contract that the mortgagor has assumed. The indenture usually includes an acceleration clause that gives the mortgagee the right to declare the entire principal of the debt due and payable at the end of this grace period. Then follows the procedure of foreclosure and other means of satisfying the defaulted claims of the mortgagee.
6. Any special privileges of the bondholder, such as the right to convert his holdings into other types of securities.
7. Position of the trustee, including a statement of his duties and liabilities.
8. Miscellaneous clauses make provision for registration of bonds, the position of the bondholders in the event of merger or consolidation, the dissolution of the corporation, etc.

**Position of Trustees.**—The trustee (usually a trust company except in those states which favor an individual person) is assumed to act as the agent and the protector of the rights of the bondholders. He is, nevertheless, selected by the corporation before there are any holders of the specific bonds in question; and, at least as a matter of convenience, he receives his compensation from the corporation. Trustees are normally presumed to make sure that only such bonds are issued as are authorized by the indenture; to record the mortgage; to receive and supervise the application of funds; to release property no longer needed from the lien of the mortgage and allow substitution of security under conditions defined in the indenture; to preserve the security by the payment of taxes, interest, and sinking-fund

installments; to see that the prescribed capital ratio is maintained; to notify the bondholders in case of default; and to protect minority interests.<sup>1</sup>

Meantime, the trustee acts as a go-between, receiving payments from the corporation and passing them on to the bondholders. The trustee is usually given the right, either upon his own initiative or upon petition of the holders of, say, 20 per cent of the bonds, to take steps to enforce the covenants agreed to by the corporation. For any such services, the trustee is compensated by the bondholders who participate in the action.

*Indentures Exempt Trustees.*—Bond indentures commonly exempt trustees from liability, from the necessity of taking the initiative, or even from having knowledge of events vitally affecting the interests of bondholders. Immunity clauses, such as the following, are used sometimes:

The recitals of fact contained herein and in the bonds issued under authority hereof . . . are not vouched for by the Trustee.

The Trustee shall have no responsibility as to the validity of this mortgage or of the lien purporting to be hereby created, or of the bonds secured hereby . . . or as to the title or value of the property hereinabove described; . . . it being understood that neither the Trustee nor any of its officers or agents have or claim to have any knowledge in regard thereto.

The Trustee shall not be required to take notice, nor shall it be deemed to have notice, of any event creating or constituting a default hereunder unless it shall have been notified in writing of such default as provided in this mortgage.

The Trustee may select and employ, in and about the execution of the trusts hereby created and the duties hereby imposed, suitable agents, solicitors, and attorneys; and the Trustee shall in no event be held liable for any neglect, omission, mistake or misconduct of any such agents, solicitors or attorneys, reasonable care being exercised in their selection.

*Responsibility Assumed by Trustee.*—Since the trustee commonly accepts no specific responsibility for protecting the interests of the bondholders, at least on its own initiative, and since it is very careful to protect its own interests by specific exemptions in the indenture and otherwise, what responsibility does the trustee assume? A common clause in bond indentures answers this question in the following words: "The Trustee shall not be liable for anything whatever in connection with this trust except by its own gross negligence or wilful misconduct."

As pointed out by Shaffner, "Cases in which liabilities are read into the instrument are exceptional. Ordinarily, the effect of the inclusion of exculpatory clauses in the indenture is to render the trustee liable only for acts of 'gross negligence or wilful misconduct.'"<sup>2</sup> Shaffner quotes a decision on the subject in which the court says: "The duty of the trustee is measured

<sup>1</sup> Manhart, R. C., *A Study of Corporate Trustees under Bond Indentures*, unpublished M.B.A. thesis, Ohio State University, 1939, p. 15.

<sup>2</sup> Shaffner, F. I., "The Problem of Investment" (New York, 1936), pp. 135, 137..

and limited by its agreement. Such agreements are legal and binding, unless they are contrary to some statute or against the public policy of the state."

*Procedure Prescribed.*—Rights of the holders of second mortgage 4 per cent 50-year bonds of the Minneapolis, St. Paul and Sault Ste. Marie Ry. Co., in case of default, are distinctly limited. No action may be taken except by the trustee, unless the trustee, upon request of the bondholders, accompanied by adequate indemnity against expenses, elects to refuse to commence action. The desire of the bondholders is determined in the following manner: First, they must have been registered for the purpose before they are entitled to vote on the question. Then, if the holders of one-fifth of the outstanding bonds request, in writing, a meeting of the bondholders, to be held in New York City, the trustee shall publish a notice of such meeting in the newspapers of New York, Minneapolis, and St. Paul once a week for 4 successive weeks.

At such meeting, bondholders registered for the purpose are entitled to one vote for each bond owned. Unless the bondholders meet and determine otherwise, the holders of a majority of all outstanding bonds is necessary for a quorum. In addition, *if* the bondholders acquire the right to vote by registering for that purpose, *if* the holders of one-fifth of the outstanding bonds request the trustee to call a meeting, *if* a quorum is present at such a meeting, and *if* the sentiment of the meeting favors positive action by the trustee to protect the interests of the bondholders, the trustee may require that any act or resolution of the bondholders be authenticated by the signatures of all persons assenting thereto.

If all the events described in the preceding paragraph should occur, the trustee may then refuse to act and resign. In such case, the board of directors of the company has 30 days to select a new trustee. If they fail to do so within the 30-day period, the holders of a majority of the outstanding bonds may select a trustee at a meeting held for the purpose. If the vacancy is not filled within 90 days after it occurs, any judge of a U.S. circuit court in Minnesota may make such an appointment, provided that he receives a written request to do so from the holders of not less than one-fifth of outstanding bonds.

Presumably, after the bondholders have done everything within their power to meet these requirements, even though there is no trustee to put their desires into effect, there is still some legal manner of protecting their interests. The bond indenture is not clear on this point. It would be interesting to read the definition of the trustee's own conception of its relationship to the bondholders under this indenture.

**Securities and Exchange Commission Investigation.**—The presence of immunity and exculpatory clauses in mortgage indentures removes much of the presumed protection that bondholders expect to receive from trustees. Courts have not been too anxious to hold trustees to more than their definite

holders of the majority of the bonds may rescind any action by any minority group.<sup>1</sup>

*Unusual Protection.*—Occasionally a bond indenture gives the trustee power to enforce its contents in most unusual ways. The first mortgage sinking fund 3s of the Granada Corp. provides for the deposit with the trustee of all capital stock of the corporation, duly endorsed in blank, together with the resignation of its officers and directors.

*Action by Bondholders Estopped.*—A “no-action” clause, common to many bond indentures, reads substantially as follows:

No holder of any bond or coupons hereby secured shall have any right to institute any suit, action or proceeding at law or in equity for the foreclosure of this mortgage, or for the execution of any trust thereof, or for the appointment of a receiver, or for any other remedy hereunder, unless such holder shall have previously given to the Trustee written notice of such default and of the continuance thereof, as herein provided; nor also, unless the holders of twenty-five per cent in amount of the bonds hereby secured then outstanding shall have made written request upon the Trustee and shall have afforded to him reasonable opportunity to proceed to exercise the powers hereinbefore granted; also he shall have offered to the Trustee security and indemnity satisfactory to the Trustee against the costs, expenses and liabilities to be incurred therein or thereby.

**Trust Indenture Act.**—Disclosures by the Securities and Exchange Commission of evidence that trustees frequently fail to represent the interests of the bondholders, or at least that they act in a dual and conflicting capacity, led to the passage of the Trust Indentures Act of 1939. This law is based upon several assumptions, the most significant of which are as follows: that the trustee lacks authority to protect bondholders' interests; that he lacks resources adequate for his responsibilities; that he may be obligated to serve the borrower instead of the lender; that the indenture may be defective and cloudy; or that the trustee is derelict in his duty. Then there is another assumption that is so basic to the theory of this particular law that it bears quotation at some length. The public, acting through governmental machinery set up for the purpose, is justified in taking action:

When by reason of the fact that trust indentures are commonly prepared by the obligor or underwriter in advance of the public offering of the securities to be issued thereunder, such investors are unable to participate in the preparation thereof, and, by reason of their lack of understanding of the situation, such investors would in any event be unable to procure the correction of the defects enumerated in this subsection.

This frank recognition of the unequal bargaining power of the average investor outlines a pattern of need for governmental intervention that, until

<sup>1</sup> *Ibid.*, p. 44.

recently, would have been condemned as paternalistic. Nevertheless, it is now the law of the land and may be merely the forerunner of similar legislation in other directions. To correct the evils complained of, the Securities and Exchange Commission is given considerable control over trustee relationships since these must be accurately defined in detail in the application for approval of securities to be issued when interstate commerce is involved or when the mails are to be used in the sale of the securities. To qualify for commission approval, the trustee must have the backing of adequate capital and must be endowed in the indenture with sufficient rights, powers, duties, and obligations to protect the interests of the bond purchasers.

The trustee must not have any other interests that would interfere with the fulfillment of his obligations under the indenture. Intercorporate involvements between the issuing corporation and the trustee are frowned upon. At least annually, trustees are required to give an accounting to the bondholders to keep them informed about the affairs of their corporation. Naturally the passage of this law met with bitter opposition. Probably the details were less odious than was the recognition that the entrance of the government into this field of regulation left a wide open door through which similar regulations may enter. Few would question the right of the government to protect investors unable to protect themselves. Much will depend upon the administration of laws like this one. If administrators go only far enough to perform their obvious duties, opposition will presently subside. If legitimate business is hampered too much with bureaucratic red tape, we may expect reactions against such legislation.

**Bond Characteristics.**—The characteristics common to most bonds are as follows:

1. *Promise to Pay.*—The first and primary characteristic is the promise of the corporation to pay a specified sum of money. The promise itself is significant and goes far to distinguish bonds from stocks, which carry no such promise. Details accompanying or qualifying this promise may add little or nothing to it. Bonds which, with elaborate care, promise to pay in "gold coin" of "present weight and fineness" should cause the prospective purchaser to be on his guard against "Greeks bearing gifts." Sometimes the only gold available is printed on the bond itself. The mention of this desirable metal may serve to distract attention from other features of the loan.

2. *Denominations.*—The face value of the bond is its denomination. The \$1,000 denomination has been the most popular one. Since the experience with Liberty bonds during the First World War, investment houses have constantly urged corporations to make use of baby bonds—of \$100 or even \$50 denomination—in order to reach the large group of small investors who never acquire as much as \$1,000 for investment at one time. Some corporations have responded to this invitation, but the practice has not become

general because of the additional initial cost of disposing of small bonds and the added clerical expense in providing for and paying interest installments. The claims for and objections to the use of baby bonds make one wonder if our experience with them has taught us anything final about them.

3. *Time of Payment.*—Most bonds have a due date stated in the promise to pay. This due date may be advanced at the discretion of the corporation if the bonds are callable; while the bondholder has the right to advance the date if the corporation fails to abide by its covenants in the bond indenture. Such failure, however, would usually indicate financial inability either to meet the requirements of the bond indenture or to retire the bonds.

In practice, the term varies from on demand to perpetuity. The Pittsburgh and Shawmut R.R. Co. has outstanding a \$1,000,000 demand note, issued in 1930, secured by \$1,000,000 of its first 5s and other collateral. Of the mortgage indebtedness of the New York Central R.R. system outstanding in 1937, under \$10,000,000 was written for 30 years or less, \$46,000,000 for 50 years, \$69,000,000 for 85 years, \$1,000,000 for 90 years, and over \$400,000,000 for 100 years. Its debentures were written for 100 years. The noncallable first gold 4s of the West Shore R.R. Co., issued in 1886, are due in 2361.

Most bonds issued in recent years are callable at the discretion of the corporation. There is a marked tendency to call them at a declining rate as the bond approaches maturity, although a sizable proportion are callable at a flat rate. The existence of a call privilege in a bond indenture facilitates future financing operations of the corporation. By its exercise a particular bond issue may be either redeemed if the corporation has excess cash that it wishes to use for this purpose, or it may be refunded if new money can be obtained more advantageously. Then too, bonds that contain restrictive clauses of any kind can be disposed of by calling them when circumstances become more favorable for refinancing them. Most bondholders, on the other hand, would prefer not to have their bonds paid off by call before maturity. The ability of the corporation to pay them is pretty good evidence that the corporation could have continued to meet its obligations. However, when a call for redemption is issued, the bondholder has no alternative but to respond. Failure to do so means that his interest payments are cut off and that the corporation holds the funds needed to repay his principal whenever he presents the bonds for redemption.

4. *Perpetual Bonds.*—Perpetual bonds are quite uncommon. The consolidated 4½s and 6s of the Lehigh Valley R.R. Co., dated 1873, are due only upon default in interest payments. They are not callable, and no sinking fund is provided. In effect, they are perpetual annuity bonds. The Buffalo and Lake Huron Ry. has outstanding perpetual first and second mortgage bonds, each bearing 5½ per cent interest. The Wilmington and Northern R.R. Co. has outstanding stock trust certificate gold 4s without



a due date (payable when redeemed, callable at 105), the interest on which is guaranteed by the Reading Co. The Atlantic Coast Line R.R. Co. has outstanding 4 per cent irredeemable certificates of indebtedness issued in 1902 in exchange for its preferred stock on the basis of \$125 in certificates for \$100 of stock. The noncumulative income is payable only if earned after paying expenses and mortgage-bond interest. In 1900, the holders of the first gold 6s of the Columbia, Newberry and Laurens R.R. Co. accepted noncumulative 5 per cent irredeemable income certificates of indebtedness, equal to 40 per cent of their holdings, as a bonus for granting a reduction in interest on their bonds from 6 to 3 per cent.

5. *Interest*.—Most bonds promise a definite rate of interest to be paid at specified times during the life of the bonds. The interest is usually paid semiannually or quarterly, more commonly the former. The specific rate varies with the type of bond, the nature of the business, and the conditions of the money market at the time the bonds are issued. Security and income usually operate in inverse proportion to each other. In some instances, a variable rate is provided for. Participating bonds are rarely used.

In advancing \$7,000,000 to pay a maturing bond issue of the Delaware and Hudson R.R. Corp., the Delaware and Hudson Co., the parent company, accepted non-interest-bearing notes as evidence of the indebtedness. It was understood that these notes would be put on an interest basis whenever the railroad company's income justified such action. Interest rates on the general mortgage bonds of the Cincinnati, Hamilton and Dayton Ry., due 1939, were fixed as follows: 1909–1911, no fixed rate,  $4\frac{1}{2}$  per cent, at the discretion of the board; 1911–1914, 1 per cent fixed rate,  $3\frac{1}{2}$  per cent, out of earnings; 1914–1916, 3 per cent fixed rate,  $1\frac{1}{2}$  per cent, out of earnings; 1916 to maturity,  $4\frac{1}{2}$  per cent fixed rate. The mortgage that secures the development and general mortgage bonds of the Southern Ry. Co. provides for an interest rate of 4 per cent. The additional interest on two series is a direct obligation of the company but is not secured by mortgage. The interest on the 6 per cent convertible debentures of Warner Bros. Pictures, Inc., is payable in cash or in common stock at the rate of  $2\frac{69}{1000}$  share for each \$15 of interest.

6. *Scrip*.—Scrip is sometimes used to pay interest on bonds. After paying interest in scrip for 1 year, at rates varying from 5 to 7 per cent on its convertible bonds, the Associated Gas and Electric Co. ceased paying interest even in scrip, because of increased taxes and decreased rates. These bonds are convertible into preferred stock at the option of the company. To meet its 1933 interest coupons on its first mortgage bonds, the Standard Textile Products Co. offered, and holders of 74 per cent of the bonds accepted, one-third in cash and two-thirds in scrip maturing in 5 years.

For the years 1933, 1934, and 1935, Saks Realty Corp. paid interest on its leasehold gold 6s, due serially to 1946, on the following basis: for each

\$30 of interest, \$20 in cash and \$12.50 in scrip, payable in 10 years. If Gimbel Brothers, Inc., should declare a dividend upon its preferred stock prior to the maturity date of the scrip, such scrip would be due immediately and payable upon its surrender. This bond-readjustment agreement was made effective by the assent of the holders of four-fifths of the outstanding bonds. In addition, each assenting bondholder agreed not to present his bonds for payment until 1 year after their maturity or until 1946, whichever should be earlier. As a result of a dividend declaration in 1936, on Gimbel Brothers, Inc., preferred stock, all outstanding scrip was redeemed, and full cash interest payments were resumed.

The Lexington and Eastern Ry. Co. issued noninterest deferred debenture scrip to pay deferred interest on its general mortgage bonds. This scrip is payable at the discretion of the company. It becomes immediately payable in case any dividends are paid on its stock. As early as 1862, the Chicago, Burlington and Quincy R.R. had outstanding noninterest scrip. The Baltimore and Ohio R.R. used scrip in 1861.

In the reorganization of the Medical Building of Houston, holders of first mortgage sinking-fund  $5\frac{1}{2}$ s received new bonds, par for par, together with scrip coupons for \$48.70, representing the balance of unpaid interest on the old bonds. This scrip is non-interest-bearing and is redeemable out of available income. If no funds become available for this purpose, the amount due ceases to be an obligation of the company.

7. *Funded Interest*.—The second mortgage 20-year 8s of the New Orleans, Arkansas and Great Western R.R. were issued to fund the overdue interest on the company's outstanding first mortgage bonds. This practice was commonly employed in the early days of American railroads. With the approval of the holders of over 70 per cent of the first mortgage sinking-fund gold 7s of the Potoreo Sugar Co., due 1947, a bond-readjustment plan was put into effect in 1932, which provided (1) to relieve the company of all sinking-fund requirements for the years 1932 and 1933, and (2) to pay 1931 interest in 6 per cent notes. In 1933, the company offered one share of preferred stock for each \$5 of interest for the years 1933 and 1934. In 1867, the state of Tennessee had outstanding loans to 21 railroads aggregating more than \$21,000,000. Funded interest, on practically all these loans, aggregated nearly \$4,000,000.

8. *Security*.—The promise to pay may be supplemented by some form of security giving further assurance of the repayment of the loan. As will be shown later, the security is an addendum to the bond and may add much, little, or nothing to its investment status.

9. *Voting Right*.—Ordinarily bonds do not have the right to vote for corporation directors. Of 6,500 bond issues sold between 1884 and 1925, Dewing found only 11 with any voice in the management of the issuing

corporation. Of the 11, 9 resulted from reorganization.<sup>1</sup> Exceptions, such as the debentures of the National Fireproofing Corp., prove the rule. The reorganization plan of this corporation gave the creditors the right to elect 6 of its 11 directors. Debenture holders were permitted to cast one vote for each \$25 of debentures. Both debenture holders and common stockholders may cumulate their votes. Holders of sinking-fund income 5s of the Northeastern Terminal Co. elect one-fourth of the directors of this company. Holders of first mortgage bonds of the California Cotton Mills Co. elect one member of the corporation's board of directors. The income bonds of the Third Avenue Ry. Co. carry one vote for each \$100.

The holders of first mortgage 20-year income bonds of the Manufactures Realty Co. are entitled to one vote for each \$100 of bonds whenever there is a default in the payment of interest on these bonds. To protect this right, the stock may not be increased without the approval of the holders of two-thirds of the bonds. Holders of first consolidated prior-lien gold 4s of the Erie R.R. Co. are entitled to cast 10 votes per \$1,000 in bonds at meetings of stockholders. Holders of income debentures of Alabama Mills, Inc., have 126 votes for each \$1,000 debenture held, representing about one-half of total voting power. Together with the common stock received with the debentures in reorganization, the holders of the two kinds of securities have three-fourths of all voting power.

The indenture covering the first and refunding 8s of the Southern Ice Co. provides that the trustee may and, upon the request of the holders of one-fourth of the bonds, shall nominate annually a majority of the directors of the company.

The sole voting power of the New Jersey and New York R.R. rests with the first mortgage bondholders (entitled to one vote for each \$100) and the preferred stockholders until dividends of 6 per cent have been paid on the preferred stock for 3 successive years. This company was incorporated in 1880. Since no dividends have ever been paid, the holders of common stock have not yet acquired voting rights.

**Tax Provisions.**—One characteristic of bond indentures that may or may not be useful to the bondholder is the presence or absence of a tax-paying provision. Moody's analysis of tax-free covenants reads as follows:

An unlimited tax-free covenant clause usually provides for payment by the issuer to the bondholder, on each interest date, of the entire nominal amount of interest called for by the obligation without deduction for any taxes, whether Federal or State, which the issuer may be required to withhold or to pay under any laws existing at the time the obligation was issued or which may be enacted in the future. Such broad clauses, as a rule, are not included in indentures and/or bonds now issued, but they occur frequently in obligations issued prior to 1918.

<sup>1</sup>Dewing, "A Study of Corporation Securities" (New York, 1934), p. 236.

The scope of tax-free covenant clauses now included in indentures and/or bonds is generally definitely defined. The borrower's obligation with respect to Federal income tax is usually limited to 2%, and the application of the clause to state taxes often is restricted to certain states mentioned in the clause and limited in each instance to a specific rate.

In addition, in some states, notably Pennsylvania and Maryland, some borrowing corporations "agree to refund upon application within a specified time and subject to other limitations indicated in the agreement" taxes paid directly by the bondholder.<sup>1</sup>

**Bond Terminology.**—The hierarchy of bonds used in American corporation finance is very complex and frequently staggers the uninitiated who attempt to understand it. A few of the terms commonly used in describing bonds are defined here in the hope of clearing the way to a better understanding of the types of bonds to be discussed in the succeeding chapters.

1. *Coupon vs. Registered.*—A bondholder may have his name and address recorded with the corporation in the process of "registering" his bond. Thereafter, transfer of such bond can be consummated only by proper authorization to register the new owner. Meantime, a lost bond can be duplicated for the loser with little difficulty, since ownership is evidenced by registration. Interest on registered bonds may be mailed directly to the owners thereof. The bond may be registered as to principal only, while attached coupons establish rights to interest payments. These are sometimes called "registered coupon bonds." Coupons are simply promises to pay the interest as and when due. Matured coupons may be detached and deposited in bank accounts, like other evidences of indebtedness. A coupon bond is not registered but may change ownership by passage from hand to hand. Because of this, the loser of a coupon bond runs greater chances than the loser of a registered bond. The former may find his property only after it has come into the hands of an innocent purchaser for value, who is therefore entitled to keep it.

2. *Mortgage Bond.*—A mortgage bond is one secured by specific property. It may constitute a prior claim or may be so far down the line of claims as to be worthless. The names used to describe mortgage bonds are similar to names on Pullman cars—they may interest and amaze the reader but seldom enlighten him. The early mortgages on English canals and railways were much like preferred stock. They had no maturity date. Interest was paid only in preference to dividends on proprietorship shares. Not until 1794 is maturity date mentioned in the statutes. In chartering a canal in that year, the act provided that the mortgage could be paid off on 6 months' notice and that the mortgagee could demand his money on similar notice.<sup>2</sup>

3. *Convertible Bond.*—A convertible bond is one which, at the discretion

<sup>1</sup> Moody, *Manual of Investments*, Industrial Securities (New York, 1942), p. a99.

<sup>2</sup> Evans, G. H., Jr., "British Corporation Finance, 1775-1850" (Baltimore, 1936), p. 47.

of its holder, may be exchanged for some other type of security issued by the corporation. Usually the bondholder sacrifices security in the hope of obtaining larger income. The conversion right must be exercised within the time limit fixed in the contract.

4. *Debenture Bond*.—This bond is sometimes called a plain bond, indicating that it is merely a promise to pay but has no security behind it. It is a much misunderstood type, as will be shown later. Its common use by well-known corporations attests its popularity. In 1936, the General Motors Acceptance Corp. offered a \$100,000,000 debenture issue, one-half due in 10 years at 3 per cent interest, and one-half, bearing  $3\frac{1}{4}$  per cent interest, due in 15 years. Both were offered at the same price, \$101.50. The proceeds were used to redeem outstanding short-term notes and to purchase receivables in the ordinary course of its business in financing the wholesale and the retail purchase of automobiles.

5. *Closed Issues*.—When a corporation is authorized by a deed of trust to issue \$1,000,000 in bonds and actually disposes of that amount, the issue is "closed." No more bonds, having the same claim, can be issued against that property. Any further issues would carry only junior security.

6. *Open Issues*.—An "open" issue authorizes further series of bonds having the same lien as those already outstanding. The holders of bonds of all series have the same claim against assets. Open issues permit either an unlimited amount of bonds or fix an upper limit, which, when reached, changes the open issue into a closed issue. For instance, a corporation authorized to issue \$5,000,000 bonds by a single indenture may see fit to dispose of only \$1,000,000 at one time. Further issues up to but not beyond \$5,000,000 could be disposed of from time to time. Or, in the case of the unlimited issues, there would be no end to the amount of bonds that could be issued with the same coverage so long as the provisions of the indenture were adhered to. These provisions aim to protect all bondholders by restricting future issues to purposes specifically defined in the indenture, such as the refunding of outstanding bonds, the acquisition of new property, etc.

In cases of acquisition of new property, or improvements to old, the new bonds to be issued are usually limited to 70 or 80 per cent of the actual expenditures, thus requiring a cushion of safety of 20 or 30 per cent for the bonds to be provided from other sources.

Illustrations of types of open issues and their limitations are as follows: The first gold 5s of the Chicago, Santa Fe and California Ry. Co., assumed by the Atchison, Topeka and Santa Fe Ry., are limited to \$35,000 per mile of road. The amount of general mortgage bonds of the Pennsylvania R.R. Co. is limited to the amount of outstanding capital stock. The refunding and general gold  $5\frac{1}{2}$ s of the Wabash Ry. Co. are limited to one and one-half times its outstanding stock, less prior mortgages. Bonds may be issued for the acquisition of new properties or securities; for extensions, betterments,

and improvements chargeable to the capital account; and for equipment, to the extent of 90 per cent of cost.

The amount of first-lien and refunding  $3\frac{3}{4}$ s of the Virginian Ry. Co. that may be issued is limited so that the amount of bonds outstanding together with all prior debt shall not exceed three times the par value of outstanding full-paid stock. In no event may the amount of these bonds exceed \$200,000,000. The Chesapeake and Ohio Ry. Co. refunding and improvement gold  $4\frac{1}{2}$ s are limited to that amount which, together with all prior debt, after deducting bonds reserved to retire prior debt, shall not exceed three times the par value of outstanding stock. The open bond issue of the Union Electric Co. of Illinois provides that additional bonds may be issued (1) up to 70 per cent of net bondable value of additions, provided that there is outstanding against such property no prior lien; (2) equal to the amount of cash deposited with the trustee as a part of the trust estate; and (3) for refunding purposes, par for par.

A study<sup>1</sup> of 960 bond issues sold during the period 1921 to 1929 showed the following percentages of open and closed issues:

Issues	Railroads	Public utility	Indus-trials	Total
Closed.....	20	16	76	52
Open with upper limit.....	54	19	21	24
Open without upper limit.....	26	65	3	24

**7. Funding or Refunding.**—These terms are used to describe bonds issued to provide the funds necessary to retire other bonds about to become due, or to retire bonds prior to maturity, when the corporation retains the call privilege and sees fit to exercise it.

**Bond Classifications.**—On the principle of grouping like with like and differentiating from the unlike, various kinds of bond classifications are found useful. Some use as the dominant characteristic the character of the issuer. Market quotations on bonds sometimes produce a classification such as that in current use by the *Commercial and Financial Chronicle*, which reads as follows:

1. United States government.
2. State and city securities.
3. Foreign government and municipals.
4. Railroads and public utilities.
5. Industrials.

Bonds may be classified on the basis of purpose of issue. One such classification includes such purposes as follows:

<sup>1</sup>Dewing, *op. cit.*, p. 220.

Adjustment	Interest
Bridge	Interim
Car trust	Purchase money
Consolidated	Refunding
Construction	Reorganization
Dock and wharf	Revenue
Equipment	Subsidy
Ferry	Temporary
Founders'	Terminal
General	Unified
Improvement	Etc.

Sometimes the classification of bonds is based upon the terms of payment. This may be either:

- (1) According to method of payment
  - a. Callable
  - b. Sinking fund
  - c. Serial
  - d. Convertible
- or (2) According to kind of payment
  - a. Gold
  - b. Currency

The most common classification is based upon the security given for payment of principal and interest. It is difficult, since some bonds are hybrids, to draw sharp lines of distinction between that group of bonds which offers specific property to secure a loan and that other group which makes no such offer. Some income bonds, for instance, are secured with respect to principal but unsecured with respect to interest. Hence, the classification given in the following chapters will require qualification and modification to provide for these exceptions to the general rules followed.

**Bond Nomenclature.**—The variety of names used to describe bonds is so great as to invite mere guessing at the meaning of some that have passed out of use. In 1867, the North Carolina R.R. had outstanding "negro" bonds; the Wilmington, Charlotte and Rutherford R.R., "anticipation" bonds; the East Tennessee and Virginia R.R., "stock" bonds; and the Erie Canal, "interest" bonds. Possibly their issuers were merely more frank than their successors. Many bondholders today have had experience with anticipation bonds; others have learned to their sorrow that they own stock bonds; many have vainly hoped that theirs were interest bonds; and some have had painful demonstration of negro (in the woodpile) bonds.

### QUESTIONS AND SUGGESTIONS

1. Distinguish between stocks and bonds.
2. Why do corporations borrow?

3. Illustrate what is meant by trading on the equity. Compare trading on the equity with external leverage.

4. What is meant by self-liquidation? To what kinds of loans does this principle apply?

5. What are the disadvantages in the use of short-term loans?

6. What is a bond? Who are the parties to a bond issue?

7. What constitutes a legal default on a bond issue?

8. Why is it essential to have a disinterested trustee for a corporation bond issue?

9. What was the background of the investigation of bond indentures by the Securities and Exchange Commission? What resulted from the recommendations of the commission?

10. Describe the Trust Indenture Act briefly, and state its purposes.

11. State the important characteristics of bonds.

12. What is meant by the call privilege attached to bonds? Who gains from its use, the corporation or the bondholder?

13. Under what circumstances are perpetual bonds used?

14. What is scrip? How is it used to pay interest on bonds? What would probably happen if a bondholder refused to accept it?

15. How is interest sometimes funded? What investment status would you expect bonds to have on which this practice was used?

16. How important are the tax provisions of bond indentures? Illustrate. What changes have been made in recent years?

17. Differentiate between registered and coupon bonds. Which are safer? Which are more commonly used? Why?

18. Differentiate between closed and open bond issues. As an investor, which do you recommend? As a corporate manager, which do you recommend?

19. What is the significance of any bond classification? How many such classifications are possible?

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### SUBJECTS FOR INVESTIGATION

1. From any manual of corporations select five bond issues and list their chief characteristics.

2. Select a corporation with bonds outstanding and show how trading on the equity affects the earnings on its common stock.

3. From a study of listed bonds reported by the *Commercial and Financial Chronicle*, find what proportion are callable. Is there any difference between railroad bonds and industrial bonds with respect to this feature?



## CHAPTER XI

### SECURED LOANS

**Meaning of Secured Loans.**—A secured bond is not necessarily a secure investment. The term “secured” does not attempt to measure the investment status of the bond. It merely indicates that, in addition to the promise to pay, the corporation issuing the bond has pledged specific assets, usually by means of a mortgage thereon. The assets may be worth much or little. The security may add much or little to the promise to pay. By 1936, nearly \$1,500,000 interest had accumulated on the \$2,750,000 first mortgage 8 per cent bonds of the Consolidated Textile Corp. The company had not earned its fixed charges since 1927. The Gainesville Midland Ry. second (now first) gold 6s, due 1916, were extended to 1919 and then to 1922. Interest has been in default since 1912. No further extensions have been granted. The company’s first gold 5s, due 1935, have been in default since 1912, without formal extension. The company’s 6 per cent coupon notes, series A and B, have been in default since 1921, without formal extension. There are outstanding 6 per cent settlement notes, due 1922, with interest payable at the option of the directors. The company has been in receivership since 1921.

Secured bonds might be called “preference bonds.” One railroad corporation adopted this terminology years ago. The Philadelphia and Chester Valley R.R. Co. has outstanding preferred gold 4s constituting a first lien on its property and nonpreferred gold 3s constituting a second lien. Both are guaranteed as to principal and interest by the Reading Co. While their claim against assets pledged is prior to all other claims with inferior or with no specific liens, this claim merely constitutes a preferential lien against such assets. It places no limit to the remedies that the bondholder may use in attempting to collect his money. Indeed, the holder of a secured bond may, if he so elects, disregard the security and sue for specific performance on the promise to pay.

**The Mortgage.**<sup>1</sup>—More often than not, a secured loan is one secured by the pledge of some kind of real estate. The form of the pledge is the mortgage. Originally a “mortgage” meant a dead pledge. If the borrower—mortgagor—failed to meet his obligations according to the terms of his contract, the lender—mortgagee—was permitted to retain the property. Later the ideas of equity of redemption, deficiency judgment, and foreclosure proceedings were introduced into mortgage practices.

<sup>1</sup> See Hoagland, H. E., “Real Estate Principles” (New York, 1940), Chap. VI.

Under modern practices the holder of a mortgage lien merely possesses the right under his mortgage, deed of trust, or whatever the instrument is called, to demand a judicial sale of the pledged assets in case of a default on the part of the mortgagor. The net proceeds of such sale—consisting of the sale price less costs of foreclosure, accrued taxes, and any other prior charges—are applied to the satisfaction of the claims of the mortgagee. Ordinarily, the mortgagee or his representatives are the chief bidders at such sale. In other words, in case of default the mortgagee usually takes over the property. In the process of foreclosure, if any balance remains after satisfying the costs of foreclosure, taxes, and other charges, and the claims of the mortgagee, it goes back to the mortgagor. On the other hand, should the net proceeds from the sale of the pledged assets fail to satisfy the claims of the mortgagee, a deficiency judgment is recorded in his favor for the remainder. This judgment constitutes an unsecured debt of the mortgagor. Its satisfaction depends upon the capacity of the mortgagor to meet his obligations from sources other than the sale of the pledged property. Being unsecured, this debt enjoys no preference over the other unsecured debts of the mortgagor.

**Classes of Secured Loans.**—A common classification of secured loans is as follows:

- A. Bonds secured by physical property
  - 1. Senior lien bonds
    - a. General first mortgage bonds
    - b. Divisional bonds
    - c. Special mortgage bonds
  - 2. Junior lien bonds
    - a. Second and subsequent mortgages
    - b. General mortgage bonds
    - c. Refunding mortgage bonds
    - d. Consolidated mortgage bonds
  - 3. Combination liens
    - a. First and refunding
    - b. First and general
- B. Bonds secured by other securities
  - 1. Collateral trust bonds
  - 2. Secured short-term notes

**Senior Lien Bonds.**—The claim of senior lien bonds against the assets pledged to protect them is superior to all other mortgage liens. It may not, however, constitute the first claim against such assets. Obligations due the government, such as taxes, would be superior to those of any mortgage lien. Courts may set aside priorities and give other claimants prior claim under certain circumstances, such as in the issue of receivers' certificates, for instance. In 1934, by court order, the Chicago and Eastern

Illinois Ry. Co. issued to the PWA trustees 4 per cent registered serial certificates of indebtedness for funds to provide for the purchase and installation of rails and fastenings. They constitute "an absolute first lien as to both principal and interest upon the property and franchises" of the company, taking precedence over all outstanding bonds. In the absence of such court decisions and governmental claims, the senior lien bondholder is expected to have first claim against assets pledged in case of a corporation's default in its promises.

A corporation may have outstanding at one time more than one senior lien bond issue. One may apply to one property and a second to another property, and so on. With respect to any specific property, the lien that has superior mortgage claim is known as the "senior" lien. This kind of lien is also known as an "underlying" mortgage in cases where subsequent claims also exist. The probability is that such mortgages were placed relatively early in the history of the corporation. They may be small in amount, in relation to the value of the pledged property. Nevertheless, their presence frequently interferes with future financing plans of the corporation.

**First Mortgage Bonds.**—First mortgage bonds are looked upon as senior lien bonds. They usually are. "What's in a name?" might well be asked of this class of security. Things are not always what they seem. First mortgage bonds may constitute not a senior but a junior lien on property. A few illustrations will make this clear. Suppose the X, Y, and Z R.R. Cos. each have first and second mortgages against their properties. Suppose now the three should combine to form the XYZ R.R. Co. The new company proceeds to issue its own first mortgage bonds. While carrying the name "first mortgage," they are quite evidently junior liens, subject to the first and second mortgages of the underlying companies. The first-lien and refunding gold 7s series A, 6½s series B, 6s series C, 5½s series D, and 5s series E of the Northern New York Utilities, Inc., constitute third liens on the company's property.

One railroad manager, finding himself in need of funds but having no property unpledged, secured money by an ingenious scheme, which is not recommended for general use. Finding among the numerous bond issues of the company those with interest rates of 4 per cent, 5 per cent, etc., but none with 4½ per cent, he proceeded to issue first mortgage 4½ per cent bonds: *i.e.*, this was the first mortgage-bond issue bearing a 4½ per cent rate of interest. The lien on assets, however, was junior to that of other bonds.

By agreement, first mortgage bondholders may waive their priority in favor of new prior-lien bonds. This is sometimes found to be expedient. In such case, the first mortgage bonds remain outstanding, but they have, by waiver, been transferred from senior lien to junior lien status.

In other words, do not take the name "first mortgage bond" too seriously. Furthermore, do not take the concept of first lien too seriously. A junior lien bond of one corporation may be a sounder investment than a senior lien of another. At its best, the first mortgage bond gives the holders thereof a first claim against specific assets pledged to protect this issue. The assets may be worthless if the corporation defaults. First mortgage is no guarantee of safety.

Even where a first mortgage is actually a first lien, there is no assurance that its holders will have their claims satisfied in full, in spite of the careful wording of the legal documents which are supposed to protect their interests. A crisis in the financial affairs of a corporation leads, more often than not, to the process of reorganization instead of to foreclosure of the claims of the first mortgage holders. Receiverships or trusteeships are obtained by other creditors which prevent the holders of first mortgages from immediately demanding foreclosure action. In the reconstruction process that is likely to follow, even the best protected claimants are frequently asked to make sacrifices which redound to the benefit of other claimants. Even where governmental agencies participate in the reorganization proceedings, there is a growing tendency to brush aside the strict construction of legal priorities on the theory that financial sacrifices should be shared rather than bear too heavily upon any one group.

In the last analysis, it is the earning capacity of the corporation instead of any priority of liens against its assets which protects its creditors. In the absence of sufficient earnings to meet their claims, asset values fade away very easily. For example, many issues of railroad bonds that constitute senior liens against the property of the issuing companies have exhibited poor market performance during the past two decades. The declining earnings of railroads as a class, coupled with gloomy prospects for the future, accounted for the low standing of these bond issues. It is interesting to note the effect of the Second World War on the prices of many such bond issues. With more favorable earnings prospects, due to the demands placed upon the railroads to handle war traffic, both passenger and freight, the prices of railroad bonds responded markedly. Naturally the increase was greater for some of the junior bonds than for some that had prior lien on assets.

**After-acquired Property Clause.**—A first mortgage, or any mortgage, for that matter, may contain an "after-acquired property clause," granting as security for the loan not only the property owned by the corporation at the time the bonds are issued, but also property to be acquired later. From the point of view of the purchaser of the bond, this clause would seem to add security; to the corporation, it might act as a hindrance to future financing. Because of this handicap, the corporation seldom puts such a clause in its mortgage voluntarily.

The indenture of the Oregon-Washington R.R. and Navigation Co. first and refunding gold 4s, constituting a first lien on some mileage and a second on an additional amount, provides coverage also of "all engines, cars and other rolling stock now owned or hereafter acquired by the railroad company, or its successors, which shall in any wise, or at any time, belong or appertain to or be provided for use upon, or for the purpose of, any of said lines of railroad." In addition, the mortgage covers "all tolls, income, rent, issues and profits thereof, in and to the same and any and every part thereof."

*Evasion of This Clause.*—At the time a corporation puts out a bond issue containing the after-acquired property clause, it probably is forced to do so because of its low credit standing. Or, thinking primarily of the current needs of the corporation, the management may not consider this clause to be a handicap to their future plans. When expansion programs are undertaken, however, their financing may be seriously hampered by the presence of after-acquired clauses in existing mortgage-bond issues. Without any intent to take advantage of the holders of such bonds, the management may feel that, in the interests of the corporation, they must find means of evading the pressure of the after-acquired clause.

It might be possible of course to go to the bondholders and explain the situation to them, with a request for a release from this clause. Since it is probable that all bondholders would be required to sign a waiver to make it effective, this plan does not appear feasible. Seldom would it be possible to induce all holders of a bond issue to sign such a waiver. For that reason, other means of evasion are usually sought. Perhaps the plan that is first thought of is the organization of a subsidiary corporation to acquire the new property. Since the original corporation would not have title to this property, any mortgage placed against it would not be affected by the existence of an after-acquired clause in another bond issue. Only the stock of the subsidiary would be owned by the original corporation. This stock might give added protection to the holders of the original bond issue.

**Purchase-money Mortgage.**—The after-acquired property clause is frequently evaded by the use of the purchase-money mortgage. In effect, the use of this type of instrument makes only the equity in the property above the mortgage subject to the after-acquired clause. For example, if a corporation acquires a property at an agreed price of \$5,000,000, paying \$1,000,000 in cash or stock and giving back to the sellers a mortgage of \$4,000,000, only the value of the property above the \$4,000,000 is subject to the after-acquired clause in other mortgages. To all intents and purposes, the purchasing corporation merely purchases a \$1,000,000 equity in the property, subject to an existing mortgage of \$4,000,000.

The same principle could be applied by having a trustee acquire title to the property in question, financing it by a bond issue, plus the contribution

made by the corporation to meet the part of the purchase price over and above the amount obtained from the sale of the bonds. Again the corporation would by this means acquire merely an equity in the property, subject to an existing purchase-money mortgage. This equity and not the value of the property would be subject to the after-acquired clauses of other mortgages.

**Other Methods of Evasion.**—There are other methods of evading after-acquired property clauses. If the bonds containing this clause are callable, they may be redeemed if their restrictions operate in a manner to hamper the financial plans of the corporation. Sometimes mergers and consolidations are so effected that, while the existing bonds are assumed by the merging corporation, their restrictive clauses are eliminated in effect. Finally, a common method of acquiring the use of additional property without taking title to it is to lease it. By this means the lessee corporation secures the right to use it and even to modify it in a manner to make it appear to be a part of the owned property. But, since title is not acquired, the value of the property leased does not come under the after-acquired clause. Should the leasehold acquire value, it would afford added protection to the bonds containing the after-acquired provisions.

**Divisional Bonds.**—In numbers of issues outstanding, divisional bonds constitute the most popular method of financing railroads. This is the result of the large numbers of consolidations in railroad history. The general first mortgage bond of a small railroad becomes a divisional bond when this railroad becomes a part of a larger organization. Or a railroad company may organize a subsidiary to build a branch and finance its construction through the direct issue of divisional bonds.

No general statement can be made about the investment status of divisional bonds. Some underlying divisional bonds have survived without sacrifice, or indeed default of any kind, the various financial crises and reorganizations that some American railroads have experienced. Other divisional bondholders, who have a claim on only the assets of unimportant branch lines, may find themselves on occasion in possession of worthless property, which the railroad managements find it unprofitable to operate any longer. The usual tests of safety of divisional bond issues are as follows:

1. Is the property covered by the mortgage self-supporting?
2. Is it essential to the success of the railroad system as a whole?
3. Is the bond issue guaranteed as to principal and interest by a strong corporation with which it is affiliated?

If the answer to any of these questions is in the affirmative, a divisional bond may be a high-grade investment; if the answers are all negative, the bonds are of little value.

While divisional bonds are discussed here as if they were senior issues,

it must be recognized that many divisional bonds constitute only junior liens against the properties covered.

**Special Mortgage Bonds.**—Bond issues may be secured by special classes of physical property, such as a railroad bridge, or terminal, or other special-purpose property. Such property may be owned by subsidiary corporations organized for that purpose. The investment status of bonds against such property depends upon three things:

1. The continued dependence upon the use of the property by the company, or companies, interested in its ownership. A railroad bridge or terminal may be completely abandoned.

2. Its salvage value, *i.e.*, the usefulness of the property for purposes other than that for which it was planned. The land upon which a special-purpose building is constructed may have sufficient value to protect the bond issue, or it may be worthless for other purposes.

3. The quality of the guarantees usually added as security for special mortgage bonds.

**Real Estate Bonds.**—One type of special mortgage bond in common use is the real estate bond—used to finance office buildings, apartment houses, theaters, garages, and other special-purpose property. The amount of bonds in relation to the cost of the property, the earning power, or the amount of stock is usually high. The bond issue is based upon the appraisal of the property, which in turn is determined by the hoped-for net earnings under favorable circumstances. It is not unfair to state that the rental schedules used as the basis for estimating earnings are usually abnormally high. Financing of most real estate projects takes place in periods of prosperity when rent levels are higher than usual. Bonds are commonly sold in anticipation of building construction. In calculating prospective earnings, vacancies are assumed to be low, depreciation is neglected, maintenance is underestimated, and rentals currently prevailing are assumed to be stabilized for the life of the bonds. Even the cost of the construction to be financed is sometimes padded in building up the financial statements used to sell the bonds.

The main issue that is too frequently overlooked in the financing of real estate projects is the fact that the cost of the property or its appraisal affords but little conclusive evidence of the investment status of real estate bonds. The main question is, how much will the property earn? Even one that earns a fair return for a while may change quickly because of a change in rent levels or a shift of uses away from the building in question. The experience with many real estate bonds has not been a happy one.<sup>1</sup>

**Junior Lien Bonds.**—By whatever title or description, junior lien bonds have claims against assets subsequent to those bond issues senior to them. Their number and size depend upon the absorptive power of the market for

<sup>1</sup>For further details about real estate bonds, see Hoagland, *op. cit.*, Chap. XXIV.

that class of bonds. They are the result, in part, of the rapidity of economic development and, in part, of the narrow restrictions upon closed senior lien bonds and those with the after-acquired property clause. Names are particularly deceptive in the use of such bonds. Second, third, etc., mortgage bonds do not appeal to the investing public because of unfortunate experiences with them. Other titles are in common use, but the product is not changed with a change in title. Not all junior lien bonds have an inferior investment status. For instance, suppose that a corporation with assets of \$1,000,000 has outstanding a senior lien bond issue of \$200,000 and a junior issue of \$200,000. The status of the latter would be higher than that of the senior bonds of another corporation similar in all respects, including asset value, but having a senior bond issue of \$500,000 outstanding. Furthermore, junior lien issues usually carry a higher rate of interest than senior issues.

As is to be expected, junior lien bonds usually bear titles that do not indicate the nature of the lien. In some instances, second mortgage bond issues are used, but more often some other title would appear on the bonds, such as "general," or "refunding." Also it should be kept in mind that in those rare instances where a third or fourth mortgage bond issue still exists it may not be a junior issue at all. It was probably issued in the early history of some railroad corporation, and the issues prior to it may have been paid off. In this case, the third or fourth mortgage bond issue actually becomes a senior bond. Some of these issues, being relatively small in comparison with the value of the property against which they constitute a lien, acquire high investment rating in spite of their names.

In considering the true meaning of the term "junior lien," it is understood that interest payments on bond issues are met in terms of priorities. The senior lien holders have first claim, the next in order comes second, and so on down the line. If the available funds are amply sufficient to meet all interest charges and other obligations on all bond issues, it would seem to make little difference that one bond issue is junior to another. All would be paid in full according to the contract. As a matter of fact, if the available funds are sufficient to meet only the obligations to the holders of the senior bonds, it is likely that even these may suffer as a consequence. Receivership and reorganization may follow, with sacrifices asked of senior lien bondholders even though there had been sufficient earnings available to meet interest charges due them.

**Subordination.**—Senior lien bonds acquire junior status when their holders agree to subordinate their claims to those of a prior lien issue. For example, there may be outstanding a first mortgage bond issue that in all respects constitutes a first lien against the earnings and the assets of the corporation. Suppose the corporation gets into financial difficulties when



it needs money. Suppose also that the only means of raising this money is through the issuance of a senior mortgage bond issue. It would be necessary to ask the holders of the existing first mortgage bonds to subordinate their claims to those of the new issue. Any minority holders who failed to waive their priority would probably have their bonds paid off if they were callable. Of course if the holders of a majority of the first mortgage bonds refused to subordinate their claims, some other solution to the financial problems of the corporation must be sought. This does not mean that another solution can always be found that would be more advantageous to the holders of the first mortgage bonds.

Holders of 7½ per cent convertible gold debentures of the Stutz Motor Car Co. of America, Inc., due 1937, agreed in 1934 to subordinate their mortgage rights to a Reconstruction Finance Corporation loan and to reduce interest payments to 3 per cent per annum, payable only from current earnings after meeting the requirements of the R.F.C. loan. Upon the payment in full of this loan, all rights and privileges under the debentures and their trust indenture are to be completely reinstated. In 1935, the Hegeler Zinc Co. applied to the R.F.C. for a loan of \$500,000. Holders of \$343,000 first mortgage 6s, due 1939, out of a total of \$348,000 outstanding agreed to take no action to assert, collect, or enforce the principal or interest on their bonds without the written consent of the R.F.C., provided that the bondholders be paid, out of the proceeds of the R.F.C. loan, \$400 per \$1,000 bond, of which \$340 was to be credited to principal and \$60 was to be retained by the bondholders as consideration for the execution and delivery of the subordination agreement.

**General Mortgage Bonds.**—General mortgage bonds are issued under various titles such as “general,” “consolidated,” and “refunding.” They may differ in minor details, but they possess the same characteristics. Historically, they follow other bond issues and at the time of issue are junior liens. The Central of Georgia Ry. Co. consolidated gold 5s are secured by second, fifth, sixth, and seventh liens on specific property and by first, second, and third liens on specific collateral. General mortgages are usually open or open-end issues and serve a variety of purposes, including the refunding of smaller underlying issues. Eventually, when all such underlying issues have been retired, the general mortgage may become a senior lien. Through the consolidation of companies, the tendency has been to make financial plans, particularly of railroads and public utilities, more and more complex. The use of the general mortgage bonds tends to reverse the process and to produce, finally, a simple financial plan with only one blanket bond issue, which, in turn, may be convertible into stock. Even general mortgage bonds may not always point toward simplicity of the financial structures of corporations. Some have only one general bond issue;

others have several. Some are issued in series. The Boston and Maine R.R. has outstanding 25 series of general mortgage bonds, bearing interest rates varying from  $4\frac{3}{4}$  to 6 per cent.

**Combination Liens.**—Not all bond issues can be classified under the titles senior and junior liens. Some carry in their names indications of combinations of senior and junior liens. Common names for such issues are “first and refunding” and “first and general.” Such names convey the impression that the bonds have first or prior claim against some property and junior claim against other property. At the time of issue, the former is likely to be much less important than the latter. In other words, a corporation that issues refunding or general bonds is not likely to own much unpledged property.

Some bond issues with a compound name may suggest the purpose for which the proceeds are to be used. For instance, in 1927, the Erie R.R. issued \$50,000,000 of 5 per cent “refunding and improvement” mortgage bonds. Approximately nine-tenths of this issue was needed to replace or refund existing bonds. The proceeds of the remainder were used to reimburse the treasury of the corporation for additions and betterments that had been financed by its cash on hand. This is a common practice, particularly in railroad finance. Treasury cash will be used for capital expenditures and will then be replaced from the proceeds of a sale of bonds.

**Collateral Trust Bonds.**—Thus far in this chapter we have considered loans secured by physical property against which mortgage bonds are commonly issued. In addition, there are bonds outstanding whose security consists of securities or other intangibles. Such bonds are called by the general name of “collateral trust bonds.” The collateral that may be used to support them covers a wide range of possibilities. The most common types of collateral include bonds of other corporations, stocks of other corporations, other bonds of the issuing corporation, and other intangibles such as leases and patents. There can be any combination of these types.

*Reasons for Use.*—Collateral trust bonds serve a variety of purposes.

1. They widen the market for small bond issues and those issued by corporations that later become inchoate. A corporation, particularly a holding company, may wish to realize upon the bonds of this sort held in its treasury. By using them collectively as collateral, the corporation may raise money through the issue of collateral trust bonds when the market would not absorb the collateral directly. It is not uncommon for holding companies to finance their subsidiaries, taking bond issues of the latter to evidence the advances made by the former. When it becomes necessary to reimburse the treasury of the holding company, it may not be easy to sell the bonds of little known subsidiaries. By using them as collateral, the better known holding company may obtain better terms by selling its own collateral-trust bonds. Indeed some of the subsidiaries may, in effect,

pass out of existence while their bonds are still outstanding. With the direct obligation of the holding company as the primary obligation, these subsidiary bonds as collateral may help to sell the collateral-trust issue. Either bonds or stocks or both may be used for these purposes.

Even though the corporation that issues the collateral trust bonds may not be a holding company, it may have in its portfolio bonds or stocks of other companies. It may become necessary, on occasion, to use these as collateral for the raising of new money.

2. Other purposes of holding companies in issuing collateral-trust bonds are numerous. Only a few are mentioned here. Corporations organized to evade the requirements of after-acquired property clauses in existing mortgages frequently have difficulty in marketing their bond issues because they are relatively small. The same is true of subsidiaries organized for other purposes, such as the evasion by the parent corporation of liability for damages. In all such cases, the parent corporation may issue collateral trust bonds against the aggregate of securities held by it from several subsidiaries. It must be remembered also that in the case of holding companies whose assets consist solely of the securities of subsidiaries, mortgage bonds may not be issued. Financing is limited to the use of stocks, debentures, and collateral-trust bonds.

3. Names may be changed by the use of collateral-trust bonds. A real estate corporation constructed a \$5,000,000 building and borrowed \$3,000,000 on first mortgage bonds. It then deposited a second mortgage for most of the balance of the cost and issued collateral trust bonds against it. The collateral-trust name attracted purchasers who would have hesitated to buy second mortgage bonds.

4. Temporary financing may be accomplished through the use of collateral trust bonds or notes. For example, a corporation which does not wish to sell long-term mortgage bonds in an unfavorable market may deposit them with a trustee and issue against them short-term collateral-trust notes. They suffer from the disadvantages already discussed for this kind of financial obligation. In case they fall due at a time when money is tighter than it was when they were issued, it might have been better for the corporation to have sold its long-term issue originally. Conversely, a corporation may take advantage of an easy money market to sell collateral trust bonds running for the period for which the corporation needs the money. For example, the New York Central R.R. had outstanding low-rate short-term collateral trust bonds secured by its higher rate long-term mortgage bonds.

**Other Intangibles.**—Ordinarily collateral trust bonds are assumed to have as security either stocks or bonds or both. In addition other intangibles, such as valuable leaseholds or franchises, are used as collateral. In most such instances, however, the collateral is not so simple in form as

in cases where bonds or stock is used. More often than not such leaseholds or franchises constitute only a part of the collateral; the remainder may be stocks or bonds or even physical property. This is particularly true in the case of leaseholds. Leasehold bonds usually have as security not only the leasehold, but also the building that has been constructed under its terms.

**Investment Trust Securities.**—Many of the securities issued by investment trusts in recent years are collateral trust bonds. A discussion of these bonds and of other financing methods of these institutions is reserved for a later chapter.

**Status of Collateral Trust Bonds.**—The investment status of collateral trust bonds may be summarized briefly as follows: A strong collateral trust bond is a high-grade security, while a weak bond of this type is even weaker than the collateral used to secure it. The tests of strength to be used in a particular case are two:

1. What is the value of the collateral?
2. What is the independent value of the promise of the issuing corporation? Like any other bond, the collateral trust bond is first and primarily a promise to pay.

If the results of these two tests are satisfactory, the collateral trust bond may take high rank as an investment. If the second test produces a negative result, then the investor would be better off if he owned directly the collateral behind his bond. Under the circumstances assumed, his only remedy against the issuing corporation in case of default would be the recovery of the collateral. This could be accomplished only at considerable expense and after expensive delays. Because of this delay and expense, the investor would be ahead if he owned the collateral originally instead of the bonds secured by it.

The strongest type of collateral is that whose market is independent of the market for securities of the corporation that issues the collateral trust bonds. This means stock and/or bonds held for investment only. Securities of subsidiary companies, either stocks or bonds, or both, are more commonly used as collateral. Such subsidiaries may have an independent value, though usually their fortunes are so closely linked to that of the parent that the market treats the securities of both parent and subsidiary alike.

**Emphasis upon Market Value.**—In the purchase of collateral trust bonds, particularly by individual bond buyers, entirely too much emphasis is likely to be placed upon the market value of the collateral at the time the bonds are issued. This is important. But if the bonds are issued during buoyant markets, the real test comes when security prices are not so high. After all it is not the liquidating value of the collateral that is so important during the life of the bonds as its earning capacity. Presumably the price is based upon the earning capacity. Nevertheless there are times during the business cycle when market prices of individual securities may be either too high

or too low because they are responsive to general market phenomena. What is most important for the holder of a collateral trust bond is an assurance that the terms of the bond contract will be met by the issuing corporation. This means earning capacity during the life of the bond and liquidating value at its maturity. Market prices meantime may be high or low, according to the swings of the cycle.

**Misleading Names.**—Legally, a collateral trust bond is a mortgage bond with stocks and/or bonds, rather than physical property, as security. In common parlance, the term "mortgage" implies the security of physical property. To call a collateral trust bond by the name "first mortgage bond" is likely to mislead those investors who never take the pains to determine the exact nature of the bond purchased. The practice is particularly bad when the collateral consists of stocks and not first mortgage bonds. The first lien collateral trust 5s of the Telephone Service Co. of Ohio are secured by common stocks of subsidiary companies. In case only stocks are used as collateral, foreclosure of the collateral trust bonds, in the event of their default, would give their holders possession of the stock only and not of any specific property. Under the circumstances, the stock would probably represent a residual claim against assets mortgaged to their full value.

**Control by Collateral Trust Bonds.**—It is possible for one corporation to obtain control of another corporation through the use of collateral trust bonds without the outlay of any appreciable amount of cash. The stock to be acquired may be deposited as collateral for the bonds to be issued. The successful disposition of the bonds transfers ownership of the stock. Or the bonds may be exchanged directly for the stock.

**Importance of Bond Indenture.**—Whatever the form of the bond, the importance of the indenture cannot be overemphasized. There is no standardized form for mortgage bonds, collateral trust bonds, or any other type. Preferred stock has been defined as being exactly like common stock except as modified by law or by contract. Bonds resemble common stock in the same manner. But the modifications are important. If the question were asked, "What are the rights of the holder of a particular bond, and what are the obligations of the corporation that issued it?" the only logical answer must be, "Read the bond indenture and find out." Should the statements contained therein be open to confusion, it might be necessary to enlist the services of a court to interpret them. Even then the court would expect the bond indenture to be self-explanatory and would rely little, if at all, upon other evidence. Hence there are few if any attributes that can be imputed out of hand to the bond concept. "The contract governs."

Even statements in a bond indenture should not be taken too seriously, unless they are supported by something more than legal promises. For example, bond indentures sometimes make gestures in the direction of

assuring the holders of the bonds of continuous security. In the indentures of collateral trust issues of the Allegheny Corp., there is a stipulation to the effect that when the market value of the collateral is less than 150 per cent of the par value of the bonds the corporation must either deposit additional collateral or retire a portion of the bonds, sufficient in either case to restore the 150 per cent ratio. In case neither of these steps is taken within 30 days, the trustee is empowered to retain all income earned on the deposited collateral until the deficiency is made up. The remedy proved utterly inadequate to prevent the collateral trust bonds from dropping to a fraction of their par value during the decade of the 1930's. Meantime, failure to maintain the 150 per cent ratio did not constitute a default in the bond contract. While it did operate to prevent the payment of dividends upon the stock of the issuing corporation, the only remedy available to the bondholders actually gave them little comfort when the market values of their bonds declined materially.

### QUESTIONS AND SUGGESTIONS

1. Are all secured bonds sound investments? Explain. Why are they sometimes called "preference" bonds?
2. What is the origin of the term "mortgage"? What is a deficiency judgment? An equity of redemption?
3. Does a senior lien constitute a first claim against the assets of the issuing corporation? Explain. Are all first mortgage bonds senior liens? Explain.
4. Explain the after-acquired property clause. How can it be evaded? Would you ever recommend its evasion? Why?
5. What is a purchase-money mortgage, and how is it used?
6. Define divisional bonds, and tell how they originate. What are the tests of the safety of a divisional bond?
7. Give illustrations of special mortgage bonds.
8. Describe real estate bonds, and account for their investment status.
9. What is a junior lien bond issue? May a junior lien become a senior lien? May a senior lien become a junior lien? Explain.
10. Suppose that a corporation earns enough to meet the obligations of its senior lien bonds but not enough to meet those of its junior lien bonds. Are the senior lien bonds safe investments? Explain.
11. What are general mortgage bonds, and why are they so called? What other names are they called?
12. Are general mortgage bonds open or closed? Why?
13. What are combination lien bonds? Give examples. Why were they used?
14. Define collateral trust bonds, and tell why they are used.
15. What is an inchoate corporation? How does it attain this status?
16. What other security besides stocks and bonds may be used as a basis for collateral trust bonds?
17. What is the difference between a lease and a leasehold? How can the latter acquire value?
18. How can you determine the investment status of a collateral trust bond?
19. Is a first mortgage collateral trust bond a senior lien? Explain.
20. How important is the bond indenture? Does it determine the investment quality of a bond issue? Explain.

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## SUBJECTS FOR INVESTIGATION

1. From the current issues of the *Commercial and Financial Chronicle* or from a recent edition of any manual select an example of each of the following kinds of bonds and justify your selection in each case. Senior lien; first mortgage; divisional; junior lien; general mortgage; combination lien; collateral trust.
2. From the same or a similar source list five bonds whose names are misleading and justify your answer in each case.
3. Find a senior bond issue that was once a junior issue. Justify your selection.

## CHAPTER XII

### UNSECURED LOANS

**Meaning.**—Bonds that have no lien upon specific property, either physical assets or stocks and bonds, are variously labeled “unsecured” or “secured by credit.” Neither term is completely satisfactory. Mortgage bonds are secured by credit, in addition to the lien upon specific property. “Unsecured” connotes lack of security. Such a condition is not always in accord with facts. Perhaps the only solution to the riddle is an attempt at clarification.

**No Pledge of Specific Property.**—Both secured and unsecured bonds use the bond indenture to establish the rights of bondholders and the obligations of the issuing corporation. They differ primarily in the absence of a definite pledge of specific property to protect unsecured loans. In other words, mortgage bonds give their holders a preference over other creditors; unsecured bonds do not. Otherwise the contents of the two indentures, including the promise to pay and other covenants, may be very similar.

**Unsecured Not Insecurity.**—The absence of specific property security may not mean weakness of the unsecured bond. In other words, unsecured does not spell insecurity. On the contrary, an indenture fixing the relations of the corporation to the holders of unsecured bonds may give greater protection to the latter than many holders of mortgage bonds enjoy.

**Classification.**—Common classifications of unsecured bonds include the following:

- A. Obligatory promises
  - 1. Debentures
  - 2. Joint bonds
  - 3. Receivers' and trustees' certificates
  - 4. Assumed bonds
  - 5. Guaranteed bonds
  - 6. Guaranteed stocks
- B. Contingent promises
  - 1. Income or adjustment bonds
  - 2. Participating bonds.

Obligatory promises place upon the corporation the necessity of meeting the terms of the bond issue or of facing the alternative of being in default. They are unrelated to the successes or financial fortunes of the corporation.



Contingent promises depend for their fulfillment upon some known contingency, such as the existence of a predetermined amount of net earnings. The latter class may leave considerable leeway of interpretation to the managers of the corporation.

**Debentures.**—A debenture bond represents an acknowledgment of a debt and a promise to pay it. It is sometimes called a “plain bond” or a “straight credit obligation.” Several series of plain bonds issued by the Boston and Maine R.R., and so designated, became secured when the company’s general mortgage bonds were issued in 1926.

English practice uses the term “debenture” in a manner that is likely to confuse American students of business finance. While the English speak frequently of “debenture stock,” what they commonly mean is the type of security that we are accustomed to designate as mortgage bond. For example, the debenture stock of Vauxhall Motors, Ltd., an English corporation controlled by General Motors Corp., is secured by the freehold and leasehold properties, buildings, and plant and machinery of the corporation and is a floating charge on all its assets. The amount of this stock outstanding is reduced annually at 103, by lot. Any stock not previously redeemed is to be retired in 1952. The debenture stock of the Anglo-Newfoundland Co., Ltd., is secured by a first specific mortgage on all freehold and leasehold lands, timber licenses, buildings, and plant and machinery, except as provided, and is a first floating charge on all other assets.

Debenture bonds have been described as inferior types of bonds in that they lack the right of foreclosure. There are two answers to this accusation. The first is that even mortgage bondholders seldom exercise their right to foreclose. In case of default in the obligations of the issuing corporation, receivership or trusteeship and reorganization usually follow. The other is that default in the obligations to debenture holders usually precipitates the same situation—receivership and reorganization. Or the debenture holders may easily acquire the right to foreclose. They may sue, get judgment, and attach specific property to satisfy the same. They now have what amounts to the right to foreclose—and to all intents and purposes are mortgage bondholders. The tests of investment strength of debentures are the earning power and credit standing of the issuing corporation. In the last analysis, these same tests must be used to determine the investment strength of mortgage bonds.

**Disadvantages.**—While debenture bonds may have high credit ratings, most of them carry a degree of uncertainty about their security that is reflected in their price. As a class, debenture bonds do not rate so high as mortgage bonds. Even individual bond issues that on careful analysis show sound security suffer from the suspicion that attaches to the name. Then, too, the life of debenture bonds is usually shorter than the life of

mortgage bonds, in spite of the fact that even mortgage bonds of very long life assume many of the characteristics of debenture bonds, because of the uncertainty of the effects of future industrial changes upon present property values.

**Protection.**—The realization of the disadvantages under which debenture bonds are offered has led bankers to insist upon restrictions and safeguards in the bond indentures whose purpose is to add protection to the bond purchaser. The most common restrictions are as follows:

1. Provision that the property owned by the issuing corporation may not be mortgaged without giving the debentures outstanding the same mortgage protection. Such a provision does not limit the future financing plans of the corporation. In effect it makes mortgage bonds out of those originally designated, and still labeled, as debentures. Sometimes also the debenture bond indenture provides that other advantages, made available in subsequent bond issues of other types, shall be extended to the holders of the debenture bonds. The agreement covering the debentures issued by the Vanadium Corp. of America provides that, if the corporation issues any obligations convertible into stock on more favorable terms than those in effect for the debentures, the same convertible conditions shall apply to the debentures.

2. Other covenants in debenture bond indentures definitely restrict the financing operations of the issuing corporation. Some prohibit the issuance of mortgage bonds so long as any debentures are outstanding. Others provide that no mortgage bonds may be issued without the consent of the holders of a designated proportion of the debenture bonds. Others place restrictions upon the issuance of more debenture bonds. Even open-market borrowings are sometimes restricted in these indentures.

3. Requirement to maintain a liberal margin of current assets over current liabilities. The Anaconda Copper Mining Co. covenants that it will not pay any dividend (other than in stock) or distribute any cash or property to any stockholders if the effect would be to reduce the net current assets of the company and its subsidiaries to (1) less than \$50,000,000, or (2) one and one-half times the aggregate principal amount of the debentures then outstanding, whichever is less.

Such restrictions are just and seem to afford the minimum protection that should be given the purchasers of debenture bonds. Future actions of a corporation may undermine the investment status of debentures, either by giving mortgage holders priority of claim against assets, or by creating current obligations of such large amounts as to jeopardize the financial integrity of the corporation and thereby weaken the credit standing of the outstanding debentures. The least protection that should be given debenture holders under such circumstances is to give them an opportunity to vote upon either practice. Even then, in order to avoid the insolvency of the

corporation, they would at times be forced to agree to proposals that caused them to waive priority of claims.

**Uses of Debentures.**—Four sets of circumstances give rise to the use of debentures:

1. Custom causes many railroads and public utilities to hesitate to issue debenture bonds because investors expect such industries to use mortgage bonds. Since the same investors are accustomed to buy debenture bonds issued by industrials, this class of corporations can resort to this method of securing capital without the handicap of investment prejudice.

2. A corporation with large earning power, but a relatively small amount of tangible assets or securities owned, has no basis for either a mortgage-bond issue or a collateral-trust issue. Its long-term loans must be in the form of debenture bonds.

3. If a corporation has such strong credit rating that investors are glad to accept its unsecured promise to pay, it need not give them the protection of specific security. It may use debenture bonds even though there is no obstacle to the use of mortgage bonds.

4. Other corporations, with weak credit standing, sometimes have no alternative but the use of debenture bonds. All their property is already pledged as much as it will carry. Further loans can be had only on promises to pay. Under such circumstances, the risk is great, and bonds can be sold only under conditions that place heavy burdens of interest charges and discounts upon the issuing corporation.

Debenture bonds are used both to obtain new capital and to refund outstanding obligations of the issuing corporation. Whenever possible, corporations entering the market for new capital would prefer to use debenture bonds instead of mortgage bonds. The former usually permits a freedom of future action not possible in the presence of the latter. In refunding operations, the same line of reasoning is often followed. It is occasionally possible for corporations to take advantage of favorable money markets to refund mortgage bonds with debentures. Also, debentures are frequently used to retire floating debt that has been accumulated in the process of plant expansion or otherwise. After accumulating \$66,044,636 in bank loans, the Columbia Gas and Electric Corp. sold \$50,000,000 of 5 per cent 30-year gold debenture bonds, using the proceeds to absorb a large part of its bank loans. In February, 1936, the U.S. Pipe and Foundry Co. incurred bank loans of \$6,000,000 for the purpose of retiring its preferred stock. In May, it sold \$5,000,000 of 10-year 3½ per cent debentures to retire its bank loans. By February, 1937, these had been reduced to \$1,099,500, largely by conversion into common stock at \$42 per share. The high price for the common stock in 1935 was \$22⅞ and in 1936, \$63⅞ per share.

Less frequently, corporations use debentures to retire preferred stock. Since the interest rate on the debentures is usually considerably lower than the dividend rate on preferred stock, a saving in charges may be effected. It should be pointed out, however, that the nature of the charges changes also. The corporation that assumes the fixed charge on a debenture issue and rids itself of a contingent charge on a preferred-stock issue may live to rue the change. The tax advantage that prompts the change may later prove to be too slight in comparison with the disadvantage of fixed-charge obligations assumed.

**Classified Debentures.**—Under English practices, described earlier in this chapter, it frequently occurs that several debenture issues will be outstanding for a specific corporation at the same time. These may be classified in such manner that some issues have preference over others. In like manner it would be possible for American corporations to issue debenture bonds in a way to give one issue preference over another. A corporation might distribute one issue for cash, giving it priority over a second issue exchanged for property. Both would be classified as unsecured loans, but one would have preference over the other. As a matter of experience, American corporations have not made use of this practice.

**Hybrid Bonds.**—Some bond issues cannot be classed strictly as either secured or unsecured, as defined in this and the preceding chapter. They partake of the nature of both. Usually this hybrid character is due to the fact that some corporation, other than the one that issues the bonds, is financially interested in its operation in a manner to induce the second corporation to assume some responsibility for the obligations of the issuing corporation. This supplemental security may add a definite advantage to the holders of the bonds. It should not be taken for granted that the assumption of a debenture obligation by a second corporation necessarily and automatically fills the gap in an otherwise weak bond.

**Assumed Bonds.**—Assumed bonds may be, and indeed usually are, of the hybrid type. In origin, they are usually mortgage bonds issued by a corporation that is later absorbed by another corporation. At the time of the merger, the merging corporation may make a declaration to the bondholders of the merged corporation that it will assume the obligations of the bonds as if it had issued them originally. Such a declaration is not legally necessary to allocate the responsibility for the bonds. The acquisition of the assets of the merged corporation, whose existence is thereupon terminated, passes the responsibility for the bonds automatically to the merging company.

Railroad corporations are the ones that frequently assume bonds, although other industries follow the practice occasionally. Originating in reorganizations and consolidations more often than not, bonds are gradually retired, refunded, or assimilated into blanket bond issues. Some of the early closed bond issues have passed through successive reorganizations, each new

company assuming these underlying issues. In assuming the 4 per cent gold stock-trust certificates of the New York, Philadelphia and Norfolk R.R. Co., the Pennsylvania R.R. Co. agreed to pay "interest and principal of the within certificate in accordance with the terms and tenor thereof, and will also pay the taxes mentioned in said certificate, and the compensation and expenses of the Trustee when and as the same become payable."

Assumed bonds are a concomitant of mergers and are therefore very common in American corporation finance. Indeed, by a succession of mergers, various corporations in turn accept responsibility for the bonds of the corporation absorbed. In any event, there is always a double protection for assumed secured bonds—that of the specific property pledged originally and that of the general credit of the corporation which assumes the obligations.

It must not be taken for granted that the addition of the general credit of a second corporation always creates a higher credit rating for bonds assumed by it. If the merging corporation is large and strong, it may add to the strength of such bonds. Its fortunes, however, are usually interlocked with those of the merged corporation, and the two rise or fall together. If they fall, the general credit of the merging corporation may disappear. At times, the fall is due to mistakes made by the merging company, so that the bonds would have been better protected had they never been assumed.

**Voluntary Assumption of Obligations.**—Although not always legally bound, parent companies sometimes assume obligations for subsidiaries to maintain their standing. For instance, the Briggs Manufacturing Co. provided an amount sufficient to pay full debenture interest and 7 per cent dividends on the common stock of its subsidiary, the Briggs Motor Bodies, Ltd., until profits of the latter were sufficient to meet its obligations.

**Guaranteed Bonds.**—These also partake of the dual nature of mortgage bonds and general credit obligations. Originating as mortgage bonds, usually, they acquire the additional protection afforded by the general credit guarantee of another corporation. This may be worth much or little. The guarantee may take the form of endorsement on the bonds, or it may be stated in a supplemental contract to be filed with the trustee. It may be implied by a lease contract that pays enough to meet the obligations on the bonds. Corporate guarantees are usually understood when guaranteed bonds are mentioned, though personal guarantees are sometimes used as a sales inducement when bonds are not readily marketable.

Three individuals jointly and severally obligated themselves, for the life of the second gold 6½s of the Broad and Walnut Corp., to purchase from the corporation, at par and accrued dividends, sufficient preferred stock to provide funds to make up any deficit in earnings required to pay interest on the bonds. When the corporation defaulted in interest payments, the bondholders' committees decided to take no action under this guarantee

since the three individuals in question had no assets that could be attached. The guarantee of the first consolidated gold  $3\frac{1}{2}$ s of the Albany and Susquehanna R.R. Co. by the Delaware and Hudson R.R. Corp. provides that the lessee shall pay principal and interest, "in gold of the present standard of weight and fineness, without deduction for any taxes which may be imposed upon the mortgagor in respect thereto, or which the mortgagor may be required by law to retain therefrom." The guarantee of the California-Arizona Lines first and refunding gold  $4\frac{1}{2}$ s by the Atchison, Topeka and Santa Fe Ry. Co. contains the following stipulation:

The Atchison Company covenants that it will pay, or cause to be paid, the interest on every bond or obligation, not constituting a lien prior to this indenture upon any part of the trust estate, as and when such interest shall become payable; and when due, it will pay the principal of all said bonds and obligations, or cause the same to be taken up and pledged under this indenture.

In guaranteeing the first mortgage bonds of the Grand Rapids and Indiana Ry. Co., the Pennsylvania R.R. Co. agrees to purchase both coupons and bonds in case of default, upon 60 days' notice by the bondholders, such bonds and coupons to be kept alive as a debt against the issuing company.

The Sun Oil Co. guarantees to the Motor Tankship Corp. an income that will enable it to pay all its operating expenses, interest, and amortization of its \$6,301,000,  $3\frac{1}{2}$  per cent, serial mortgage bonds, maturing from 1935 to 1950. To date, the Motor Tankship Corp. income has been in excess of these requirements.

Bond guarantees are elusive. A cooper who once advertised his products as "fully guaranteed" was asked what that meant. He responded, "I guarantee that my products are barrels." Bond guarantees may be equally illuminating. The guarantee may be of both interest and principal, of principal alone, or of interest alone. If the last, the guarantee may run through the life of the bond, or for a short time only, until an unproductive property acquires earning capacity. Full interest may be guaranteed or only a minimum rate, less than the amount stated in the bond. "The contract governs."

**Joint Bonds.**—Joint bonds belong to the hybrid class. In origin, they are usually mortgage bonds issued against some single-purpose property, such as a railroad bridge or terminal. As such, they would be worthless, perhaps, should the property cease to perform the function for which it was constructed. The issuing company usually has no independent financial resources, since it is generally organized merely to take title to the property mortgaged. Its income consists of rentals intended merely to pay the carrying charges on the bonds, taxes, and the expenses incidental to the corporate existence. Under these circumstances, few investors would care to buy the mortgage bonds of such a corporation.

In order to overcome this handicap and give such bonds marketability, the company, or companies, using the property guarantee the payment of the principal and interest. This guarantee carries no specific security but is usually sufficiently valuable to give the desired credit standing to the bond issue. Hence, while, in origin, joint bonds have mortgage security, their real strength comes from the general credit of the corporations that guarantee them. The first gold 4s of the Chicago Union Station Co. are guaranteed jointly and severally, both principal and interest, by the C. B. and Q., the C. M. St. P. and P., the P. C. C. and St. L., and the Pennsylvania R.R. companies by endorsement. The stock of the Station Co. is all owned by the guarantors.

**Guaranteed Stocks.**—The guarantee by one corporation of dividends on the stock of another, usually a subsidiary, partakes of the same nature as a guarantee of bond interest. Such dividends become an unsecured debt of the parent corporation and may be collected in the same manner as any other unsecured debt. Guaranteed stocks are not so well protected as guaranteed bonds and will not fare so well in times of crisis. In reorganizations, for example, guaranteed stocks would be expected to suffer greater sacrifices than guaranteed bonds, for the latter can always resort to a foreclosure against the property that usually protects them. The former have no such recourse.

In 1896, the property of the Little Schuylkill Navigation, R.R. and Coal Co. was leased for 999 years to the Philadelphia and Reading R.R. Co. at a rental of organization expenses and 5 per cent on its stock. Federal taxes, not assumed by the lessee, have resulted in a reduction of the net return on the stock. Under the terms of the lease to the Pennsylvania R.R. Co., 7 per cent dividends on both common (formerly guaranteed special stock) and preferred stocks (formerly original stock) of the Pittsburgh, Fort Wayne and Chicago R.R. are guaranteed by the lessee. The prices of these stocks exhibit but little fluctuation in comparison with most railroad stocks. Indeed some guaranteed stocks are maintained at higher prices than are the bonds of the guaranteeing company. In January, 1939, the 7 per cent stock of the Peoria and Bureau Valley R.R., guaranteed by the Rock Island R.R. Co., sold at approximately par value. The Rock Island General (first) mortgage 4s of 1988 sold at the same time at 15. They had been in default since 1934.<sup>1</sup>

On the other hand, holders of guaranteed stocks, lacking the lien on assets usually found in guaranteed bonds, may find themselves in a position that calls for adjustments in their claims or even complete abandonment of their guarantees. For example, consider the following case: The preferred stock of Huyler's of Delaware, Inc., was guaranteed unconditionally by Schulte Retail Stores Corp., the controlling company, as follows: (1) payment of 7

<sup>1</sup> Grossman, L. W., "Investment Principles and Practices" (New York, 1939), p. 93.

per cent dividend beginning with 1927; (2) purchase of all preferred stock at par and accrued dividends after 60 days' default in dividends; (3) payment of par and accrued dividends in case of dissolution, liquidation, or sale of assets. In 1933, a committee of preferred stockholders agreed to modify this agreement by a guarantee of 4 per cent instead of 7 per cent for a period of 5 years from 1933. In 1937, the Federal court, New York, directed the Schulte company to reject this guarantee.

**Investment Status.**—The investment status of guaranteed bonds is determined by three sets of conditions:

1. The independent earning power of the issuing corporation, together with the liquidation value of the assets securing the bond issue. Obviously, if the earning power of the issuing corporation is sufficient to meet the obligations of the bond issue and if the liquidation value of assets will be sufficient to satisfy the bondholders in case of default, the guarantee of the bonds by another corporation is unnecessary. If either of these factors is absent, a guarantee may be valuable.

2. The nature of the guarantee. Only such obligations as the guarantor assumes give any protection to the bondholders. It is always important to analyze the guarantee carefully.

3. Ability of the guarantor. The third determinant of the investment status of guaranteed bonds is the ability of the guarantor to live up to his contract when the crisis comes. It is easy for a prosperous parent corporation to give assurances of guarantee to the holders of bonds of a subsidiary. It may be difficult to make such promises good later if the subsidiary defaults. The fortunes of the parent company usually parallel those of the subsidiary. If the latter defaults, the former is not likely to be in a position to render much assistance. In attempting to avert failure, the parent has usually taken on other obligations of a nature to give other claimants prior claim over its assets in case of failure.

Furthermore, divorce courts give new meanings to "forever and ever." Equity courts at times redefine guarantees. An equity receiver may repudiate unprofitable guarantees made by a corporation that fails. Even without failure, a corporation may change its mind and notify the holders of the guaranteed bonds that it repudiates all responsibility for the bonds. The holders thereof can sue for performance and throw the guarantor into the hands of receivers, who in turn would probably ignore the guarantee. In other words, the guarantee may be worthless because the guarantor cannot be held to his obligations.

**Income Bonds.**—Income bonds are sometimes like guinea pigs. The latter are not pigs, and they did not come from Guinea: otherwise, it is perfectly proper to call them guinea pigs. Income bonds may not really be bonds, and they may pay the holders no income: hence it is equally proper to call them income bonds. Their guinea-pig status has become so well



known in recent years, however, that even the name has been changed to "adjustment" bonds.

They too belong to the hybrid class. They are generally secured as to principal but depend for their income upon the earnings of the issuing corporation and the good faith of its board of directors. They usually have a due date. Therefore, the corporation may be sued and the property securing the bonds foreclosed at maturity in case the promise to pay the principal is not fulfilled. Greater uncertainty attaches to the receipt of income.

The Central of Georgia Ry. Co. has outstanding first, second, and third preference income bonds secured by mortgage on property of the company, junior to some mortgage bonds and senior to the company's refunding and general bonds. The collateral-trust cumulative income  $7\frac{1}{2}$ s of the Taylor-Wharton Iron and Steel Co. are entitled to cumulative interest, to be paid on or before the maturity date of the bonds. These bonds are secured by a direct first mortgage on the company's plants and on certain collateral deposited with the trustee.

The Avery and Sons Co. had outstanding in 1937, 6 per cent notes, series A and B. The former were issued to preferred creditors in the 1932 reorganization and carry a fixed rate of interest. The latter, while being secured by a first mortgage, receive only such interest as is earned, after allocation of 50 per cent of net profits to the payment of the principal of series A notes and after restoring accumulated deficits from operations of the company since the date of the notes. Although the holders of the second mortgage income 5s of the Texas and Pacific Ry. Co., due 2000, have no right of foreclosure on default of interest payments (unless the holders of the first mortgage bonds foreclose), the trustee is required, upon the request of the holders of one-third of the bonds, to take over the property and operate it under the direction of a committee selected by the bondholders, until defaulted interest is paid in full.

**Origin.**—The first American income bonds were issued by the Chesapeake and Ohio Canal Co. in 1848.<sup>1</sup> They were used by the Cleveland and Pittsburgh R.R. as early as 1866. Corporations seldom issue income bonds for sale in the open market. They almost always originate in reorganization. When a corporation's earnings are insufficient to meet fixed charges on its funded debt, these charges may be scaled down. One method used is to substitute contingent charges for fixed charges—income bonds, either under this title or some other, are offered to mortgage bondholders in exchange for their present holdings. They have no other alternative than to accept, reluctantly.

**Combination Income Bonds.**—Not only are income bonds to be classed as hybrid issues, but occasionally a corporation issues bonds that combine

<sup>1</sup> Dewing, A. S., "A Study of Corporation Securities" (New York, 1934), p. 318.

fixed and contingent interest. When the Scullin Steel Co. found it necessary to reorganize its capital structure, it induced its first mortgage bondholders to give up their claim to 6 per cent fixed interest in exchange for 3 per cent fixed and 3 per cent if earned. The maturity date was extended from 1941 to 1951, and sinking-fund requirements were waived for a period of 5 years. As an inducement, the bondholders were given, for each \$1,000 bond, detachable warrants, good for 5 years, to buy 20 shares of common stock at \$10 per share.

The sinking-fund income 5s of the Northeastern Terminal Co. are secured by a first closed mortgage on land and industrial buildings. The real estate securing these bonds may be sold and released from their lien by payment to the trustee of the net sale price in cash; or, by the assignment of mortgages or contracts. These bonds are entitled to accumulated interest of 5 per cent from the date of their issue in 1936 to 1940. Thereafter, the interest becomes a fixed charge at 3 per cent, with 2 per cent additional if earned. The 2 per cent is cumulative from 1940 to the maturity date of the bonds in 1948 and is payable at maturity. Interest on the general income 6s of the Indiana Limestone Corp. is cumulative, but the accumulations of interest do not bear interest. Upon the retirement of all prior-lien 6s, the payment of current interest on the general-income 6s becomes an unconditional obligation.

**Interest Provisions.**—Various plans for meeting—and evading—interest charges on income bonds are in use. In the first place, payment of any interest is contingent upon earnings. If interest is not earned, it is not paid. If interest charges are noncumulative, the failure of the corporation to earn the interest in any year cancels the right of the income bondholder ever to expect payment. If the interest is cumulative, however, he may have hopes of collecting it at a later and happier day. Some income-bond indentures provide for noncumulative interest for a period of time sufficient to allow the reorganized corporation to recover its economic health; thereafter, it may be cumulative. Under such circumstances, it is remarkable how the recovery of health coincides with the change from noncumulative to cumulative interest obligations. In rare instances, income-bond reserve funds are provided for in the indenture to help take care of interest obligations in lean years. Recent issues of income bonds—under whatever name—have tended toward cumulative interest requirements. This is merely a preferential charge against earnings since, in the absence of earnings, the bondholder has no legal means of enforcing his claim. Indeed, he has no legal claim in the absence of earnings.

Interest on the 5 per cent income debentures of the National Radiator Corp. is payable only when earned, but is cumulative. All arrears of interest are due, whether or not earned, at the maturity date of the bonds. The interest on the first income 6s of the Old Ben Coal Corp. is payable only as earned for the years 1934 to 1939. Beginning 1940, any net earnings from

preferred, and Class B debentures are common stock, so far as income distribution is concerned.

**Participating Bonds.**—The type of general-credit bond least commonly used is the participating bond. This too is a hybrid type, since the bond itself may give its holder mortgage protection. Regular interest rates are paid as fixed charges. In addition, the holders of participating bonds are entitled to share in excess earnings of the corporation. The conditions of such participation must be carefully defined to prevent misunderstandings and controversies. In rare instances, bonds have been made participating to appeal to the speculatively minded investors. Since speculators are better satisfied with an increase in price rather than an increase in yield, this appeal can be better served by the use of the conversion privilege, stock-purchase warrants, etc. Participating bonds are seldom used.

In 1930, Siemens and Halske A.G. (a German corporation that floated securities in this country) issued 1,000-year participating debentures, with a fixed interest rate of 6 per cent and an additional payment sufficient to make the total equal to the dividend on its common stock for the preceding year. These debentures are callable at any time after 1942. After they have been issued for 75 years, any series of debentures may be presented to the company for repayment on 6 months' notice. The indenture contains provisions for the protection of debenture holders in case of liquidation, merger, consolidation, sale of assets, or dilution of common stock. Certain provisions of the debentures may be modified with the consent of the holders of 80 per cent of those outstanding.

**Receivers' Certificates.**—When a corporation fails and its control passes into the hands of an equity court, its treasury is usually depleted, its physical property is in need of repairs, and its facilities are out of date. Failure does not usually occur overnight. Frequently, every means available is exhausted before its presence is admitted. This means cessation of construction, starvation of maintenance, conversion of all available assets into cash, and operation on thin margins. Consequently, one of the first jobs of the equity court and of its agent, the receiver in equity, is to find some cash with which to operate the business, pending final disposition of its embarrassments. The court may even decide to rehabilitate the corporation and bring its property up to date before relinquishing control over it.

In order to obtain whatever money or materials the receiver and the court decide is necessary and desirable, the court authorizes the issuance of receivers' certificates, the payment of which is secured by the property and the credit of the corporation. The receiver for the Seaboard Air Line Ry. had outstanding, in 1935, 26 series of receivers' certificates, aggregating nearly \$25,000,000. In effect, the court declares a moratorium on all corporate debts in default and gives receivers' certificates precedence over them. Even court decisions have called these certificates obligations of the

court and not of the corporation. They are authorized by the court; but the court is under no obligation to pay them if the corporation's property is insufficient to liquidate them when due. Indeed, instances have been known where a receiver, unable to meet his obligations, has passed into the hands of a receiver.

Receivers' certificates have such priority, after taxes and claims for current wages and supplies, as the court under whose jurisdiction they are issued sees fit to give them. Occasionally they are secured by the pledge of specific property. The 4 per cent trustees' certificates of the Western Pacific R. R. Co. constitute a first lien on all property of the company now owned or hereafter acquired, prior in right to the company's debts and obligations and to any lien created by it. These certificates were offered in 1936 to the first mortgage bondholders, at par, on a prorata basis. The issue was underwritten by the R.F.C.

The liens of receivers' certificates of the Wabash Ry. Co. are as follows:

Series	Nature of lien	On special collateral
First series. . . . .	Prior to general and refunding mortgage	Second lien
Second series. . . . .	Prior to general and refunding mortgage	Second lien
Series A . . . . .	Prior to general and refunding mortgage	First lien
Series B . . . . .	Junior to general and refunding mortgage	First lien
Serial certificates. . . . .	Prior to general and refunding mortgage	Second lien

Since receivers' certificates are usually issued to meet temporary demands for cash, they have early maturity. It is expected that they will be retired by payment, or by funding, before the corporation's control passes out of the hands of the court. The refinancing program resulting from reorganization is expected to provide the funds for their retirement. At times, with the consent of their holders, they may be funded into other types of securities, usually bonds. If the affairs of the corporation at the time of reorganization are distinctly discouraging, the holders of receivers' certificates may be coerced into making sacrifices of one sort or another.

Receivers' certificates do not enjoy high credit rating with the mass of investors. Their complicated nature causes many to avoid them. Their short life is a handicap in investment markets. Many investors associate them with the failure of the corporation, when as a matter of fact they may be unusually well protected. They are generally absorbed by those with a definite interest in the corporation rather than by outside, impartial investors.

**Trustees' Certificates.**—Since the passage of the Chandler Act in 1938, the trustees appointed by Federal courts have found it necessary to raise

money in much the same manner employed by equity receivers in earlier years. The section (116) of Chapter X which deals with this question reads as follows: the court may authorize a "receiver, trustee or debtor in possession . . . to issue certificates of indebtedness for cash, property, or other consideration approved by the judge, upon such terms and conditions and with such security and priority in payment over existing obligations, secured or unsecured, as in the particular case may be equitable." This places the issuance of trustees' certificates approximately on a par with the issuance of receivers' certificates under the direction of a court of equity.

**Bonds as Investments.**—Although there are no comprehensive statistical studies to justify the commonly accepted conclusions, bonds as a class are presumed to be safer investments than other kinds of securities. Because of this presumption, they bear a lower rate of return than is expected on stocks, they are usually denied voting rights, they are frequently callable, and they suffer from various other disabilities. In arriving at conclusions concerning the investment status of bonds, we are inclined to consult the lawyer rather than the accountant and the statistician. The lawyer reads the bond indenture and informs us of the position of priority that the bondholder occupies in relation to all other claimants against the assets and the earnings of the corporation. There is no intent to minimize the importance of the bond indenture. It does establish contractual relationships between the bondholder and the corporation. It does establish the legal rights of the bondholder. But what about the performance?

The flood of corporate reorganizations that appear as the result of every economic depression, with its accompanying grist of sacrifices on the part of the holders of many bond issues, raises interesting questions about the sufficiency of well-phrased legal documents. It is probably true that, as a class, bondholders fare better than stockholders, both in relation to regularity of income and to security of principal investment. Again let us remember that there are no comprehensive statistical studies to support this supposition beyond the shadow of a doubt. There are plenty of individual experiences to support the boast of both regularity of income and stability of principal of stock commitments. Alongside these are untold instances of losses suffered by bondholders, both in contractual income and in principal investment. Even if there were statistical studies to compare bond investment with stock investment, as a comparison of classes of securities, they would unquestionably demonstrate the need for careful case study before a commitment in either class is undertaken.

From what has already been said it should be evident that, even legally, bonds cannot always be readily distinguished from stocks. In fact there is not a single attribute of either bonds or stocks that may not be possessed by the other class of security. As stated in Chapter X, if you would undertake to array all possible kinds of stocks and bonds in a manner to

list the soundest, best-protected bond at the top, the most common garden variety of stock at the bottom, and all other kinds of stocks and bonds properly placed between these two extremes, you could not draw a dividing line at any point with the assurance that above that line you would have only bonds and below it only stocks. It would be possible to divide such a listing of securities into three zones, according to commonly accepted definitions of stocks and bonds. The top zone would include only bonds; the bottom zone, only stocks; but the middle zone would include both stocks and bonds, each possessing one or more of the attributes of the other.

We have already shown how the "common-stock" theory of investments applies with equal force to the purchase of preferred stocks. It applies also to bond purchases. If any generalization about bonds as investments is required, it would have to be couched in some such language as the following: money invested (1) over a period of years, (2) in a well-diversified holding of bonds, (3) of representative corporations, (4) in essential industries, (5) tends to measure up to the reasonable expectations of the investor. All of which means that, in selecting bonds for investment, there are ample opportunities for mistakes unless all the above limitations are observed. Even then the element of timing is important. In periods of depression, bond prices decline sharply. Also corporate failures in nonessential industries and among unrepresentative companies drag down with them not only stock values, but bond prices as well.

No investor can, with impunity, buy just any bond at any time and feel secure in his hope of a regular income and a stable principal. The soundest investments are discovered only after careful search. The novice who lacks competent advice in the selection of individual bonds will probably lose less if he follows the practice of buying prior-lien bonds of "representative companies" in "essential industries." Final tests of soundness of bond investment are dependent upon the careful and expert analysis of individual corporations, rather than upon broad generalizations about classes of securities. It is generally recognized that stock values depend upon earning power rather than upon asset values. In the last analysis, bond values have the same foundation. For asset values themselves are determined by the earnings these assets are able to produce for their owners. Hence again we return to the earnings of each individual company.

### QUESTIONS AND SUGGESTIONS

1. What is the nature of an unsecured bond?
2. Why is a debenture bond sometimes called a plain bond? What do the English mean by debenture?
3. How valid is the argument that holders of debenture bonds lack the right of foreclosure in case of default?
4. By what means may the holders of debenture bonds be protected? Do you approve of such protective features? Why?

5. Under what circumstances are debentures used? What is the chief advantage and the chief disadvantage in refunding preferred stock with debenture bonds?

6. What is an assumed bond? Is it always a better bond because it is assumed? Explain. How do such bonds originate?

7. How does an assumed bond differ from a guaranteed bond? Which is the more sound investment? Why?

8. What are joint bonds? Why are they used?

9. In what way do guaranteed stocks partake of the nature of debenture bonds? Which are better protected, guaranteed bonds or guaranteed stocks? Why?

10. Compare the fluctuations in the price of the preferred stock of the Pittsburg, Fort Wayne and Chicago R.R. with the fluctuations in the price of the stock of the lessor, the Pennsylvania R.R., and account for the differences. (See Moody's *Manuals*.)

11. State the origin and define the nature of income bonds. What are combination income bonds?

12. What risks do the holders of income bonds run in trying to collect their interest? Compare income bonds and preferred stock.

13. What are participating bonds? How frequently are they used? Why?

14. Describe receivers' certificates, and state the conditions under which they are used. What priority is given them? By whom? Are they really the obligations of the court? What ensures their repayment?

15. When the receivership is lifted, what happens to the receivers' certificates?

16. In determining the investment status of bonds, who should be consulted, the lawyer or the accountant? Why?

17. Name any attribute of bonds that is never possessed by stocks, or vice versa?

18. What generalization can you state about bonds as investments?

19. In evaluating bonds, which is more important, assets or earning power? Why?

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### SUBJECTS FOR INVESTIGATION

1. From any manual of railroad corporations find an example of each of the following kinds of bonds: debenture, joint, receivers' certificate, assumed, guaranteed bond, guaranteed stock, income or adjustment bond.
2. List the characteristics of the debenture bond named above.
3. List the characteristics of the income bond named above.

## CHAPTER XIII

### TRUST CERTIFICATES

**Uses.**—In the preceding chapters, we have discussed various kinds of stocks and bonds and have indicated the usual attributes that differentiate each from the others. Trust certificates, discussed in this chapter, constitute a kind of corporate security that is neither stock nor bond. They are neither evidences of creditorship, nor do they possess the usual attributes of ownership shares. They employ the principles of the simple trust described in an earlier chapter. They were used first in an extensive manner in the financing of railroad equipment. Here they came to be almost the sole means of financing such purchases. Later the same principles were employed in the financing of many real estate projects. In recent years, trust certificates have been used in the financing of airplanes, other transportation equipment, machinery used in factories and other productive processes, etc.

#### I. EQUIPMENT TRUST CERTIFICATES

**Methods of Financing Equipment.**—Railroad fixed capital, including tracks, stations, etc., is usually financed by the use of stocks and bonds. Indeed the capital structures of most American railroads have become exceedingly complex because of the amounts and varieties of bonds used in this industry. Meantime, financing of railroad rolling stock is capable of being molded into different patterns than its other capital because it is movable and can readily be transferred to other railroads if necessary. At the same time, the use of this rolling stock is just as essential to the operation of the railroad as are its tracks and terminals. These conditions make possible unique types of financing for rolling stock that are not available in the financing of other capital. In the financing of its equipment, three plans have been used by railroads.

**Equipment Mortgages.**—The equipment mortgage is a simple chattel mortgage, with the equipment as the security. The railroad company acquires title to the equipment and mortgages it to provide a large part of its purchase price. This was the plan commonly used by the railroads in earlier periods. Because of the superiority of other plans, this one is almost never used any more. It is interesting to note in passing that, when it was used extensively, equipment bonds bore a relatively high rate of interest. In view of current experiences with equipment obligations, this earlier high rate seems strange indeed. Had all railroads maintained high credit stand-



ing, it is possible that we would still be using equipment bonds to finance railroad rolling stock.

**Conditional-sale Plan.**—Because railroad finance became involved in numerous failures, other plans of financing equipment were evolved. As already pointed out, the mobility of the equipment made possible types of financing that could not be used in the purchase of other kinds of railroad capital. One of these is the conditional-sale plan. Under this plan, the railroad buys its equipment on the installment plan, leaving legal title thereto in the name of the manufacturer or of a trustee appointed for the purpose. As in other installment purchases, the buyer makes a down payment and pays the balance of the purchase price over a series of years. When all installments have been met, title is transferred to the railroad company. The use of this method of financing railroad equipment is clouded in some states by court decisions in which conditional sales are looked upon as actual immediate transfers of title, with a purchase-money mortgage retained by the seller. As a consequence, the seller encounters difficulty in repossessing the property in case of default. The court decisions consider that the equity of the purchaser is subject to the after-acquired clauses in other mortgages. Since there is available still a third plan of financing railroad equipment, which avoids the weaknesses of the conditional sale, this third plan has acquired almost universal acceptance in the financing of railroad rolling stock.

**Philadelphia Plan.**—The most common method of financing railroad equipment in modern use is the so-called "Philadelphia plan" of leasing the equipment to the railroad company. Under this plan, the railroad company places an order for equipment to be constructed according to specifications. It makes a down payment, the size being determined by the kind of equipment, the credit standing of the railroad company, the condition of the money market, and the bargaining power of the contracting parties. Highly specialized equipment, that is used by only a small number of companies, would ordinarily require a larger down payment than that which is standard for many companies. Likewise the lower the credit standing of the railroad company, the larger the percentage of the down payment. For most types of equipment, the amount of the down payment is fairly well standardized.

**Title.**—The location of title to equipment purchased under the Philadelphia, or lease, plan gives this form of financing place in this chapter. The manufacturer sells, but the railroad company does not buy, the equipment. Instead, a trust company or some other trustee becomes the legal owner. The railroad, let us say, pays the manufacturer the original 20 per cent of the cost of the equipment. The other 80 per cent is supplied by bankers and eventually by investors. Unless the manufacturer should take trust certificates in part payment for the equipment, he is now out of the picture. He has passed legal title to the trust company or its substitute.

Even when the manufacturer of the equipment retains a part of the equipment trust certificates, the legal title remains with the trustee. The manufacturer is simply the owner of certificates of beneficial interest which are liquidated in the same manner as similar holdings of other owners.

**Lease.**—The trust company, acting as the legal owner of the equipment, then leases the equipment to the railroad that has made the down payment on it. The lessee obligates itself as follows:

1. To pay annually to the lessor—in addition to the charges for his services—a sum of money sufficient to meet the agreed upon return upon all outstanding certificates, plus the amount needed to amortize the principal of the certificates within the period agreed upon. The period of amortization is always less than the estimated useful life of the equipment. For example, if ordinary freight cars are estimated to have a useful life of 22 years, the period of amortization of the equipment trust certificates used to finance them would probably be 15 years. In form, the annual payments made by the railroad company to the trustee constitute the rental paid for the use of the equipment. In fact, they constitute a return upon the use of funds advanced, plus the amortization of these funds.

2. To maintain the equipment in good repair, to keep it insured, and to replace any units destroyed by fire or otherwise. It is expected of course that the equipment will gradually wear out. This gradual depreciation is offset by the payments described in the preceding paragraph. To make sure that only such gradual depreciation will need to be accounted for by the trustee, unusual opportunities for loss, due to complete destruction of the equipment or to failure to keep it in repair, are provided for separately.

3. To carry on each unit of equipment a name plate indicating its legal owner. When you see blazoned across the side of a freight car the name of some railroad company, you assume that this company owns the car. More often than not it is merely the lessee. If you look carefully, you will find a brass plate attached to the frame of the car in an inconspicuous spot, telling you that the real legal owner is some trust company.

4. To assemble and deliver to the lessor at a designated place all equipment covered by the lease in case the lessee fails to meet its obligations when due. Since the lessee's rights to use the equipment cease immediately upon default of any clause in the lease, the rights of the lessor to repossess his property without delay is acknowledged in the lease.

As soon as the last payment called for in the lease has been made, assuming that all other terms of the lease have been fulfilled, the lessor is obligated to pass legal title to the equipment to the railroad company. From then on the equipment may be owned outright by the former lessee. Since the equipment trust certificates are expected to be amortized some years before the equipment is due to be scrapped, the railroad may enjoy the use

of its own property for this period without being obligated to make any payments on it other than for insurance and repairs.

**Equitable Ownership.**—When a trust company undertakes to finance railroad equipment and to act as its legal owner, it expects to dispose of the certificates needed to finance the equipment as soon as possible. Individual investors and financial institutions of various kinds become the purchasers. As a result, legal ownership of the equipment continues to rest with the trust company; but beneficial ownership passes to the purchasers of the equipment trust certificates. Such certificates are not bonds. They cannot be considered credit instruments of a railroad company that has no title to the equipment. Neither are they shares of stock. In case of default by the lessee, the lessor merely exercises his right of repossession in the hope of releasing the equipment to some other railroad that will assume the obligations of the lease, or as an alternative, to sell the equipment to the best advantage and distribute the proceeds among the certificate holders. Meantime the equipment trust certificate owners are the joint owners of the equipment, but without direct control over it. The control rests with the trustee. Hence these certificates are merely certificates of beneficial interest—in other words, of equitable ownership—in an undivided and indivisible property represented by the aggregate of the equipment under consideration. As such they should not be called either stocks or bonds.

**Serial Repayment.**—Equipment trust certificates are issued in series. The shortest term is one year, while the longest would be determined by the length of the life of the lease. In case of some certificates, this might be 15 years, while in others it might be somewhat shorter or longer. Each year the trustee receives from the railroad company a principal installment, along with the part of the rental that is needed to pay a return upon the investment. From the latter the trustee deducts his commission and pays the remainder to the owners of the certificates. The amount represented by the principal installment, meantime, is used to retire the certificates due at that time. The varying terms of the certificates call for varying rates of return upon them. Those with the shortest periods of amortization pay the lowest rate of return. The rate increases with the length of the maturity. The rates charged in individual instances will reflect not only the credit standing of the lessee and the time the certificates are to be outstanding, but the cost of money at the time the certificates are issued. In 1931, the New York Central R.R. Co. leased equipment that was financed by a series of 15-year equipment trust certificates bearing rates of return varying from  $2\frac{1}{2}$  to  $4\frac{1}{8}$  per cent. In 1937 the Chicago, Burlington and Quincy R.R. was responsible for the issuance of a series of 10-year equipment trust certificates at rates varying from 0.85 to 2.7 per cent. In 1947 the Chesapeake and Ohio Ry. financed equipment with 10-year certificates at rates varying from 1.00 to 1.75 per cent.

**Nature of Security.**—Any attempt to state the investment quality of equipment trust certificates must start from a recognition of the peculiar nature of the security upon which they are based.

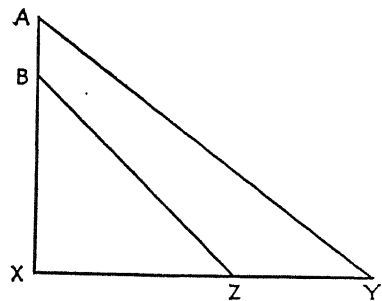
1. A railroad company may operate successfully without certain of its branch lines or may even abandon a terminal or station now and then. It can hardly operate without equipment. The equipment covering any particular issue of certificates is frequently diversified. If only one type is used, it is likely to be that most often used by the railroad. Because the equipment is indispensable to the operation of the railroad leasing it, defaults in the obligations to holders of equipment trust certificates have been rare indeed.

2. Should a railroad default in rental payments, it would be fairly easy, under normal conditions, to dispose of the equipment to another company using the same type.

3. The life of the equipment is longer than the life of the certificates issued against it. Actuarial experience with different types of equipment makes possible accurate estimates of the effective life of railroad equipment. It is always desirable for the railroad to meet its last installments in order to acquire title to property with several years of service still available.

4. Obsolescence is not a large factor in the value of railroad equipment. Fundamental changes take place slowly and do not often render completely obsolete the equipment in use at any time. Depreciation is less rapid than the absorption of the unpaid balance of installments in the form of rentals.

**Investment Status.**—As a consequence of the preceding factors of value, equipment trust certificates properly enjoy a relatively high rating with investors. The margin of safety supplied at the outset by the lessee constantly increases, for the unpaid balance is absorbed more rapidly than the decline in value due to depreciation and obsolescence. The protection of the holder of the certificates is indicated in the diagram.



$AX$  is the original cost of the equipment.  $AB$  is the down payment made by the railroad.  $XY$  is the effective life of the equipment.  $XZ$  is the number of years necessary to pay off the balance of the purchase price. At the end of any year, indicated on the line  $XZ$ , a line perpendicular to  $XZ$  would strike the line  $BZ$  at a point that would measure the balance due on the equipment at that time. The line  $AY$  is assumed to represent the decline in value of the equipment. This line exaggerates the rate of value consumption, since such value decline would not be in a straight line. In the absence of drastic declines in prices, the value would

always be as great as the line indicates, however. Therefore if the line drawn perpendicular to *XZ* should be extended through *BZ* to its intersection with *AY*, the part between *BZ* and *AY* would represent the margin of safety for the holders of the certificates at that time. By observation, it is easily seen that this margin is constantly increasing through the life of the certificates.

The few defaults in the long history of the use of equipment trust certificates represent a negligible percentage of those used, in both number and volume. Grossman's study of defaults in equipment obligations of bankrupt railroads in the period 1931-1938 is quite revealing.<sup>1</sup> In the case of 16 railroads, having outstanding 73 issues of equipment trust certificates, neither the principal nor the rate of return was disturbed when the company became involved. In three other railroads the principal and the rate of return on 23 issues were maintained but the maturity dates were extended. Twenty-three issues of two railroads were exchanged for either receivers' certificates or trustees' certificates without any reduction in principal. In only one issue of 120 studied were the holders of the equipment trust certificates required to take a loss in principal.

**Equipment Obligations Exempt.**—It is pointed out frequently that when a corporation gets into financial difficulty and finds it necessary to resort to some kind of a reorganization procedure, it is not uncommon for a receiver or other public authority to abrogate leases and to cancel other contracts. In view of this practice, it is interesting to note that when Section 77 of the National Bankruptcy Act, dealing with the reorganization of railroads, was enacted it contained the following clause:

The title of any owner, whether as trustee or otherwise, to rolling stock equipment leased or conditionally sold to the debtor, and any right of such owner to take possession of such property in compliance with the provisions of any such lease or conditional sale contract shall not be affected by the provisions of this section.

**Uses of Equipment Trust Certificates.**—Equipment trust certificates were first used by the Schuylkill Navigation Co. in 1845 in the purchase of barges. It was not until 1868 that the plan was extended to the railroad field. In that year, the Lehigh Coal and Navigation Co. used them to finance railroad equipment for the first time.<sup>2</sup> For some years thereafter the plan was used only by railroads with weak credit. Lacking the financial ability to finance their new equipment by any other means, weak railroads used the Philadelphia plan. Gradually other and stronger roads saw the advantages that came from this form of financing. As a consequence, practically all railroads now use this method of financing their equipment. The costs are much lower

<sup>1</sup> Grossman, L. W., "Investment Principles and Practice" (New York, 1939), p. 22.

<sup>2</sup> Dewing, A. S., "A Study of Corporation Securities" (New York, 1934), pp. 331-332.

than for the best of prior-lien bonds. Even though railroads with weak credit are asked to pay somewhat higher charges than the stronger companies in this field, the costs are still much lower than they would be required to pay for any other form of financing. For reasons already given, the carrying charges on railroad equipment are more or less unrelated to the credit of the companies that accept obligations for paying for the equipment by this means. For example, railroad companies with weak credit may have first mortgage bonds selling on the market to yield two to three times as much interest as similar bonds of the companies with strong credit ratings. Meantime the rates of return on equipment trust certificates of the two classes of companies may vary but little.

**Application of Idea.**—The same principles that govern the use of equipment trust certificates in the railroad industry may apply with equal force in other industries. While the idea of equipment trust certificates as a means of financing railroad equipment is particularly effective in this industry, because of the standardization of such property and the absence of obsolescence, it may be used, with modifications, to finance equipment in other industries as well. The safeguards to be employed are: actuarial determination of the effective life of equipment financed, or at least its careful estimate; the compensation of the factor of obsolescence; and the means at hand of disposing of recaptured equipment in case of default. Bus corporations, industrials, and even airplane companies have made successful use of equipment trust certificates to finance their equipment. As yet, however, railroads have made more general use of the idea than has any other industry in the purchase of equipment.

The popularity of equipment trust certificates as a means of financing railroad rolling stock is due in part to long acquaintance with their performance. At the outset their use in this industry was confined to companies with weak credit and then only at higher rates of return than are common now. Gradually, as more experience was accumulated, both railroad companies and investors favored the extension of their use. It is to be expected that until we know more about the effective life of airplanes, for example, investors who purchase equipment trust certificates to finance them will insist upon a relatively high rate of return and a short period of amortization. Both of these will probably become more favorable to the lessee corporations as we learn more about the operations of such companies. The ideas embodied in the equipment trust certificates are probably applicable to situations where they have not yet been applied.

At the same time it must be recognized that, outside the field of railroad rolling stock, the use of equipment trust certificates presents some problems that are not serious in the railroad industry. As pointed out already, railroad rolling stock is well standardized. A freight car owned by one company fits readily into a train of another company. For that reason the problem

of disposal, should repossession become necessary, is not a serious one for trustees under railroad equipment trust certificates to solve. Lack of such standardization in other industries might interfere somewhat with the smooth operation of disposal of repossessed equipment. While there would probably be a market for repossessed equipment, it might be in the nature of a sacrifice market rather than the substitute ownership and use arrangements available in the railroad industry. However, these differences do not argue against the use of equipment trust certificates in other industries. They merely create new problems that call for attention and solution in connection with the use of this method of financing.

## II. LAND TRUST CERTIFICATES

**Origin.**—Similar in nature to equipment trust certificates are land trust certificates, which acquired quite a vogue during the decade of the 1920's. In an earlier chapter, the use of the Massachusetts trust was described. It originated from the refusal of the Commonwealth of Massachusetts to sanction the organization of corporations to deal in real estate. With the rise in speculative fever during the decade of the 1920's, not only were stocks and bonds common subjects for financial manipulation but other forms of speculation were common. Among these were various devices for the financing of real estate. Taking a leaf from the experiences of the use of the Massachusetts trust, many real estate projects were financed in a manner that paralleled the use of equipment trust certificates in the railroad industry. The parallel was not too exact, however, as the following discussion will demonstrate.

**Local Character.**—In the first place, it must be recognized that when land trust certificates are used they apply to a single site, available for a specialized use, and limited in size sufficient only to serve that use. It cannot be moved about as can railroad rolling stock. Furthermore, this site will be developed by the construction of a building needed to make the designated use effective. The presence of this building further limits the future use of the site. For example, if a theater is constructed on the site, the use of the site for the construction of a building for an entirely different type of use is prevented. It is quite probable that the demolition loss that would result from tearing down the building would prevent its replacement by a different kind of structure. Likewise, the cost of remodeling for an entirely different use might prevent such modification in the structure. Hence, although the legal structure of land trust certificates parallels the structure of equipment trust certificates, economic differences may be very important.

**Title.**—Where a site for a building to be used by a merchandising, financial, amusement, residential, or other purpose is to be financed by the use of land trust certificates, its legal title is transferred to a trustee, usually a bank or trust company. It is understood that the other features of the

set-up, including the lease, are already agreed upon at the time the trustee takes legal title to the property. It is understood also that the bank or trust company takes title as trustee for the benefit of the beneficial owners of the property. It does not follow, however, that the land trust certificates have been sold at the time the legal title changes hands. Indeed it is likely that the certificates have not even been offered for sale up to this time.

**Beneficial Ownership.**—Whatever the form of ownership at the time legal title is passed to the trustee, it is the hope of the owners to dispose of their interests in the land by the sale of land trust certificates. Such certificates are not bonds. No corporation obligates itself to pay interest on them or to retire them at maturity. In many instances, they have no maturity date. Nor are these land trust certificates stock. They lack several of the attributes of stock ownership. They have been variously called "fee ownership certificates," "shares of equitable ownership," and "certificates of beneficial interest," in addition to the more common title of "land trust certificates." Each of these names is suggestive of their nature. Collectively the certificate holders own the "fee" of the site. Each owner possesses a "share" of the equitable ownership in the property and is entitled to participate in the "beneficial interest" accruing from its use. Like equipment trust certificates, land trust certificates represent equitable ownership in an undivided and indivisible piece of property, represented in this case by a site for some kind of building.

Courts seem to be undecided whether to class land trust certificates as real estate or personal property. While the question has not yet been finally adjudicated, the evidence at hand seems to lean in the direction of considering them real estate interests. When land trust certificates were substituted for serial bonds in the financing of the site for the Insurance Exchange Building (Boston), it was ruled that the certificates need not be listed for personal-property tax purposes. When the county auditor attempted to tax the land trust certificates underlying the Midham Corp. leasehold, a permanent injunction to restrain such tax was obtained. Again the court took the position that land trust certificates merely represent fractional interests in real estate. While these decisions are important, it should be noted that in these cases there were no complications of the kind that will be pointed out presently.

Whatever the legal character of the land trust certificates, it is the hope of the owner of the property, at the time the legal title to the land passes to the trustee, that he will be able to dispose of his interest in it. The means used is the sale of land trust certificates for an aggregate amount to equal the value placed by the former owner upon the land. Each certificate represents a face value of, usually, \$500 or \$1,000. Some have a face value as low as \$100. One buyer may purchase one or more. Not infrequently the trustee acts as the sales agent for the certificates. If all certificates are sold,



the former owner of the land, like the manufacturer of railroad equipment financed by equipment trust certificates, may be out of the picture. If any remain unsold, he is their owner. As long as any other land trust certificates are owned by others, the arrangement for their use could not be canceled nor could the former owner again become the legal owner. Incidentally, it is frequently possible for the owner of a site to obtain somewhat more from its sale to many owners by the use of land trust certificates than by the sale of the fee to a single owner. This accounts for a part of the use of certificate financing during the decade of the 1920's.

**Nature of Rental Payments.**—Both the transfer of the legal title to a trustee and the sale of land trust certificates against the site are predicated upon the previous leasing of the property. Indeed the sales appeal in the disposition of the certificates is the existence of a favorable lease to a supposedly reliable tenant. The obligation of the tenant or lessee starts with the payment by him of all taxes, assessments, and other governmental charges against the property. As a consequence, the land trust certificates are supposed to be tax free. Next the lessee agrees to pay to the lessor, the legal owner, an annual rental that is sufficient in amount to pay a fixed return to the holders of the land trust certificates and to compensate the trustee for his management of the property.

**Option to Purchase.**—Some leases give to the lessee an option to purchase the fee of the property. Ordinarily the option price is somewhat more than the aggregate of the land trust certificates outstanding, resulting in a premium to the certificate holders for giving up their investment. This premium corresponds in kind and in amount to that payable to bondholders whose bonds are called before maturity. The existence of an option given to the lessee to buy the fee raises some interesting legal questions about the nature of the land trust certificates. Does this option change them from fractional interests in real estate to personal property?

Let us take one step more. Suppose that, in addition to the option to purchase, the lessee pays to the trustee an annual amount over and above his compensation and the return to the certificate holders which is expected eventually to amortize the outstanding certificates. Do such land trust certificates still retain their status as real estate interests or are they now definitely personal property? The courts have not yet decided some of these questions. Meantime a few illustrations will show what practices are sometimes followed.

The rental agreement with the lessee of the Lamson Brothers Store Building provided, in addition to the annual payment of \$52.50 on each \$1,000 land trust certificate, a quarterly payment into a depreciation fund to be held by the trustee and invested in either United States government bonds or the previously mentioned land trust certificates, the latter to be purchased in the open market or by call. The fund is subject to quarterly

additions by the lessee until it amounts to \$1,000,000. The lessee has an option to buy the property at \$1,339,000, plus accrued rental, less the amount in the depreciation fund.

More complicated arrangements exist in the financing of some real estate sites. In the use of land trust certificates in financing the Kansas City Title and Trust Co. Building what amounted to two separate issues of certificates was used. Those which represented the ownership and the first claim to the income from the lease were to be amortized by the lessee over a period of 60 years. The annual rentals were sufficient to pay 5 per cent on the original issue of land trust certificates, to discharge the trustee's compensation, and to amortize the actual investment in the time specified. After these certificates were paid off and canceled, another issue would represent the ownership in the land. The latter were to receive no income until the first issue of certificates had all been paid off and canceled.

**Position of Trustee.**—As in any other type of financing on a large scale, the appointment of a trustee makes possible the participation by a large number of people in the investment in a single project. The trustee under land trust certificates differs but little from the trustee under a mortgage-bond issue. To be sure, he has legal title to the property against which the land trust certificates are issued. This does not necessarily mean, however, any greater protection for the investor. The trustee has no investment in the enterprise other than the fiduciary relationship that he bears to the real investors. He may or may not assume leadership in protecting their interests if the lease covenants are not lived up to.

**Protection.**—Without the lease, land trust certificates could hardly be classed as high-grade investments, since a site for a business structure could be sold to a large number of small investors at a price in excess of the amount any single individual would pay for it. The lease to a responsible party gives such investors two sorts of protection: (1) It assures an income sufficient to liquidate their annual claims. (2) It also obligates the lessee to construct a building, if one suitable to the site is not already in existence. This building affords protection to the principal of the land trust certificates, since they would have prior claim against the entire property in case of default. In order to ensure the construction of the building, one of the provisions of the lease sets forth its description and frequently requires the posting of a bond to require the lessee to fulfill that part of his contract.

**Example of Land Trust Certificates.**—The Michigan Office and Theater Building in Detroit was financed in part by the issuance of land trust certificates. The land was appraised at \$4,645,960 and the land and buildings at \$8,157,783. Against the land, 4,500 equal shares in the undivided fee were sold at \$1,000 each. The certificates were to receive \$55 payment per annum. Against total charges for this purpose of \$247,500, it was estimated that there would be available for ground rent \$468,519. The lessee retained the right

to purchase the fee by paying an amount sufficient to retire the certificates at \$1,040 each if the option was exercised by 1932; at \$1,030, by 1937; and thereafter at \$1,020, with accrued rental added in each case.

**Financing of Construction.**—Where land trust certificates are used to finance the site, buildings already constructed thereon, or to be constructed, are usually financed largely by bonds. It is not uncommon for such bonds to carry such titles as “first mortgage leasehold” bonds. Literally this title is a statement of fact, in that the bonds are the first ones issued against the leasehold. Actually, however, all such bonds constitute a junior claim against the property since the holders of the land trust certificates possess a first claim against the building as well as the site. Assuming that the lessee has some of his own money invested in the building, it would be expected to be absorbed first if he is unable to meet the terms of the lease. Legally at least, the next group of shock absorbers would be the holders of the leasehold bonds. Presumably their interests would be sacrificed in time of crisis before those of the land trust certificate holders would be placed in jeopardy. In effect, therefore, first the equity of the lessee and then the investment of the leasehold bondholders are expected to serve as cushions of safety to protect the investment of the holders of the land trust certificates.

It is even quite probable that, where land trust certificates underlie leasehold bonds, the investment status of the bonds is likely to be less well protected than if only bonds were issued against the entire property, land, lease, and building. For example, where the land is financed by the sale of land trust certificates, it is expected that the aggregate of the certificates will at least equal the full value of the land, regardless of any “appraisal” that may be placed upon it for the purpose of boosting the sale of the certificates. The only exception might occur when the same owner owns both land and building. It is conceivable that in such case the aggregate value of the land trust certificates might be less than the value of the land. Meantime, the amount of leasehold bonds to be sold would be stated as a percentage of the value of the building and the lease. For example, the site on which the Bankers’ Building of Chicago is constructed was financed by the sale of 5,000 land trust certificates at \$1,000 each. The building to be erected was appraised at \$6,972,000. It was financed by the sale of a \$5,000,000 issue of first mortgage leasehold bonds, which obviously were a second lien since they were subject to the claims of the underlying land trust certificates. In this case the leasehold bonds represented 72 per cent of the appraised value of the building. But the sum of the land trust certificates and the leasehold bonds represented nearly 84 per cent of the appraised value of the building plus the value of the land, assuming that the aggregate of the land trust certificates represented its value.

**Certificate Holders’ Remedies.**—To get back to the land trust certificates, let us take a look at what happens when a lessee fails to fulfill his obligations.

Like many other contracts, a breach on the part of one of the contractors gives the other party the right to cancel the contract. If the lessee fails to live up to his covenants, the lessor has the right to dispossess him and thereby to acquire possession of the real estate. Should there be no other claimants against this property, perhaps the trustee for the land trust certificates may take possession not only of the site, but of the building as well. When there are other claimants involved, action is not quite so simple. Any action taken must include other claimants also. This usually means resort to receivership until final disposition of claims is possible.

Meantime, it is frequently possible to reach new agreements when old ones cannot be carried out. It is not unusual for a lessee in financial embarrassment to ask for temporary or permanent adjustment of his obligations. The lease to the Midham Corp. covered two theaters, one at Middletown and the other at Hamilton, Ohio. As originally written, the contract with the trustee for the land trust certificates called for an annual payment of \$18,000 into the depreciation fund. By mutual agreement this was reduced in 1935 to \$3,000, with no other change in the lease contract. Frequently changes involve reduction in income to the holders of the land trust certificates as well. The Morehouse Martens Realty Co. (Columbus) had outstanding 1,250 land trust certificates, originally entitled to \$52.50 per \$1,000 certificate per year. After the lessee defaulted on its contract, fixed charge payments were reduced to \$30 per \$1,000 certificate per year for the period 1934-1956.

Sometimes adjustments in rental payments partake of the nature of income-bond interest. In 1934, the lease of the Northwestern Building Site (Portland, Ore.) was modified to provide for an annual rental of not less than \$40,500 per year. So long as this amount is paid the lease cannot be canceled by the lessor. In addition, the lessee obligates himself to pay up to \$74,250 per year if earned. In like manner the lease to the Wade Park Manor Corp. (Cleveland) was modified in 1932 to provide that rentals are payable only as earned up to 6 per cent on the land trust certificates, but that the 6 per cent annual return is cumulative and must be paid before any interest can be paid to the leasehold bondholders. The latter were also put on an income basis when the lease was modified as the result of a foreclosure in 1932.

In still other cases the holders of the land trust certificates take sole possession of the property after wiping out all other interests. When the Dayton-Biltmore Hotel (Dayton) defaulted on its land trust certificates in 1930, receivership followed. As a result, both the equity of the lessee in the hotel and its equipment and the interest of the leasehold bondholders were completely wiped out. The trustee for the land trust certificates obtained possession of the property free of these other claimants. Although this action gave the holders of the certificates possession not only of the land

that they financed, but also of the building and equipment financed by others, it did not give them an assurance of either income or security of principal. Since for some time after the property was taken over it failed to earn any net return, nothing was paid to the holders of the land trust certificates. It is not surprising that they sold at a greatly depreciated price.

**Uses of Land Trust Certificates.**—Land trust certificates were used freely throughout the decade of the 1920's, both in financing sites for business property and in refinancing such properties. In many instances they were the means by which owners of vacant land or land about to be changed to a new use were enabled to sell their property at prices as high as or higher than they would have been able to obtain from the sale to individuals or corporations. Lessee corporations were frequently able to minimize their investments by the fact that the site was owned by scattered investors. Land trust certificates were used also to refinance properties already constructed. Financial and mercantile corporations that owned their properties found the sale of land trust certificates against these properties an effective means of releasing capital tied up in real estate which they could use to better advantage in their normal business operations. By retaining an option to buy back their sites, they were permitted to reacquire title to them whenever circumstances warranted. It was not uncommon for such corporations which sold land trust certificates in the decade of the 1920's to exercise their option to purchase when they could mortgage their properties to advantage during the late 1930's.

**Importance of Appraisal.**—In spite of what has been said about the protection given the holders of land trust certificates by the lease and the improvements, careful attention should be paid to the appraisal of the land and of the building constructed or to be constructed thereon. If the property is inflated too much, and if the building does not "fit" the uses to which it is put, its acquisition by the holders of land trust certificates might place them in possession of a liability rather than an asset.

**Weaknesses of Land Trust Certificates.**—If proper appraisals support the amount of certificates issued and if the building contemplated is erected, the chances for real estate decline to jeopardize the integrity of the certificates are not great. Drastic declines in price levels, carrying real estate on a downward spiral, or shifts in real estate uses may wipe out all values above the land trust certificates and even produce a situation in which no income is available to the certificate holders. The certificates without the payments under the lease would undoubtedly decline in value.

Like other types of real property, the real estate that supports the land trust certificate is subject to declines in value during periods of depression which are not compensated by increases in demand. Being a nonliquid asset, real estate does not invite speculative bidding when values decline. If it becomes necessary for the holders of land trust certificates to take over the

property, the likelihood of leasing it under favorable circumstances is subject to important limitations, at least so long as the depression continues. This means that the investors who bought the land trust certificates for their income may find themselves in the position of real estate speculators.

Another weakness of land trust certificates is inherent in the nature of the certificate. Most of them have been issued in denominations of \$1,000. Some are in denominations of \$500 and even \$100. This invites the attention of not the smallest investor but the medium small. Since there is no occasion for any organization of certificate holders, they have no opportunity to work together or even to know who their fellow investors are. If there is a breach of the lease, the lessee alone would probably take the initiative in proposing changes—since the trustee is unlikely to take the initiative in protecting the certificate holders. Consequently, in a period of depression, with little or no demand for the property financed by the land trust certificates, the lessee may take advantage of the certificate holders by offering a modification in the lease that may work to the advantage of leasehold bondholders or even the lessee directly, at the expense of the certificate holders. Absence of organization makes the latter more or less defenseless against such proposals.

**Investment Status.**—In summarizing the investment status of land trust certificates, the following points should be observed:

1. The certificates are assumed to be tax exempt so far as their owners are concerned. The lessee is supposed to pay all taxes. On this point it is well to make sure that the lease is so drawn that there is no question about not only current taxes, but also those which may be levied in the future.

2. The lessee assumes all burdens of management of the property. The income paid for its use is net, and all of it is passed on to the holders of the certificates except the part that is retained by the trustee as his compensation for managing the trust.

3. Under the most favorable circumstances, ownership of land trust certificates must be considered as a long-term investment, devoid of the advantages that may accrue to the holders of speculative securities. For the most part, they represent a nonliquid investment. Marketability is limited to an over-the-counter operation and by the reputation of the house of issue and its connections. If they are well and favorably known, an owner of land trust certificates may dispose of them in normal markets by sale through the house of issue. If they are listed at all, it will be only on the local exchange whose operations are largely confined to the city in which the property is located. In other words, such market as they possess is likely to be quite narrow.

4. In like manner the collateral value for loans depends upon the attitude of local banks toward them. If the owner lives in a city other than that in which the real estate underlying the certificates is located, it is not likely that his bank will look with favor upon loans based upon the certificates.

On the other hand, banks located in the same city with the real estate may give reasonable consideration to the collateral value of the certificates, particularly if they know the lessee favorably.

5. Opportunities for appreciation in the principal of the investment are usually limited to the amount of the redemption premiums, if any. Even such profit to the holder of the certificates is unwanted. If the option to buy the fee is exercised and the certificates are purchased at a premium, it would be only at a time when the owners would prefer to retain their investment. While the certificate owners collectively own the land, any increments in site value that may accrue are usually absorbed by the lessee because his long-term lease is usually renewable. It is always possible of course to arrange the renewals at higher rentals than the original lease. But since, where land trust certificates are used to finance the fee, the owner who arranges for the lease does not think in terms of its future rentals, the likelihood of graded rentals is not so great as if the original lessor expected to retain ownership of the fee.

6. In view of the preceding limitations the real test of the investment status of land trust certificates is the earning capacity of the lessee. In this respect these certificates are like high-grade bonds or any other investment securities. Income to the certificate holders is dependent upon the rentals received from the lessee which are, in turn, dependent upon his earning capacity. If he is successful, he will undoubtedly pay his rent as contracted for. If he is unsuccessful, he cannot pay the contract rent indefinitely. In case of his default, several possibilities are open to the trustee and the holders of the certificates. None of them assure a continuation of the amount of return agreed upon in the original lease. A compromise may be effected by which the rent is reduced, either temporarily or permanently. The lease may be canceled, and a new lease may be made with another lessee. Or the owners of the land trust certificates may authorize the cancellation of the lease, and then they may undertake to operate the property for their own account. Since there is always the probability that a default on the part of the original lessee is due to adverse economic conditions, or even to a mistake in the location of the building, the chances of getting more from the use of the property from some other source than the original lessee are not too good. The best protection for the holders of the land trust certificates lies in the continued earning capacity of the original lessee.

### QUESTIONS AND SUGGESTIONS

1. What are the methods of financing railroad equipment? What differentiates rolling stock from other railroad capital, as far as its financing is concerned?
2. Who holds legal title to the equipment under the Philadelphia plan? What rights has the railroad company under this plan?
3. What obligations does the railroad company assume?
4. When, if ever, does the railroad company become the owner of the equipment?

5. Who are the equitable owners? What is the nature of equipment trust certificates? What are the advantages of their serial repayment?

6. Account for the investment status of these certificates. What has been their loss experience?

7. Why are the carrying charges on railroad equipment more or less unrelated to the credit standing of the companies that use it?

8. To what other financial situations may the principles of the equipment trust certificates apply?

9. What modifications are necessary in air transportation? Why?

10. What was the origin of land trust certificates? How do they differ from equipment trust certificates?

11. Compare the scope of the markets for the two types of certificates. How does the maturity of the two differ?

12. Are land trust certificates real estate or personal property? Does an option to purchase the land complicate the answer to this question?

13. What protection do the owners of land trust certificates have?

14. How is the building construction financed where land trust certificates are used?

15. What are the remedies of the holders of land trust certificate in case of a default by the lessee?

16. What are the uses of land trust certificates?

17. How important is the appraisal of the land? Why?

18. What are the weaknesses of land trust certificates in comparison with equipment trust certificates?

19. How would you determine the investment status of land trust certificates?

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#### SUBJECTS FOR INVESTIGATION

1. From the quotations section of a recent issue of the *Commercial and Financial Chronicle*, find the effective rate of return upon the latest issue of equipment trust certificates of two railroads. Compare these rates with the corresponding rates of interest upon the largest bond issues of the same railroads. Account for any differences that you find.

2. Find three examples of leasehold bonds and account for their rates of interest.

3. Do the prices of these leasehold bonds fluctuate much over the years?



## CHAPTER XIV

### EXTINCTION OF INDEBTEDNESS

**Significance of Due Date.**—A bond is a promise to pay a specified sum of money at a time specified in the bond and called the “due date” or “date of maturity.” In some cases, it is intended to liquidate such obligations from accumulated earnings. In other cases, the due date means nothing more than the date of renewal of the debt, or of shifting it from one set of creditors to another. In still other cases, it may mean the limit of time within which the corporation is expected to make some provision for changing the form of the indebtedness.

**Debt-extinction Practices.**—In general, we may classify corporations into two groups on the basis of their attitude toward extinction of their debt. Railroads and public utilities are likely to consider much of their debt permanent in fact, whatever its form. A part of this attitude is to be accounted for by the nature of the industry and a part by the character of the assets employed in it. There has been an assumption that railroads and public utilities are so essential to our economic life that they will necessarily be with us always. Recent experience has somewhat shaken our faith in this philosophy. Also in these industries we find a high percentage of fixed assets that have been used as the basis for the issuance of mortgage bonds. It must not be overlooked also that the loss of faith in the continuing need for railroads has not resulted in a decrease of their indebtedness. Whatever may have been the desires of railroad managements during the past few decades, their abilities to get out from under their burdens of debt have been very limited except during the Second World War years. A study of the history of railroad finance, particularly in the period since the decade of the 1870's, has shown a definite trend toward a maintenance of and even of an increase in total debt outstanding.

**Railroad Experience.**—In the light of recent difficulties encountered by American railroads in meeting fixed charges, their early experiences with bonds are of interest. Increase in outstanding stock and decrease in bonds were common up to about 1870. In 1861, the Boston and Providence R.R. had outstanding \$3,160,000 stock and \$132,720 bonds; by 1867, the stock had increased to \$3,360,000, and the bonds had been retired. In 1861, the Philadelphia and Reading R.R. had outstanding 11 bond issues, most of which, together with its preferred stock, had sinking-fund provisions. Up to 1870, its ratio of stock to bonds was 10 to 3; in 1871, 3 to 2; and in 1873, 7 to 8. In 1867, the South Carolina R.R. had outstanding several issues of

pound bonds and 17 domestic issues. Only one exceeded \$125,000 in amount or 20 years to maturity.

In 1862, the Erie R.R. had outstanding first, second, third, fourth, and fifth mortgage bonds as well as common and preferred stocks. The ratio of stock to bonds was about 1 to 1. In the same year, the Pittsburgh, Fort Wayne and Chicago Ry., formed to reorganize its failed predecessor, issued first, second, and third mortgage bonds maturing in 50 years. This is the first instance of American railroad bonds with so long a maturity. Interest rates on bonds of early American railroads were much higher than those common today. In spite of the ratio of stock to funded debt of 12 to 7 in 1862, the outstanding bonds of the New York Central R.R. were all 6s and 7s. This represented the low of interest rates on such bonds at that time. In many other railroads, bond interest rates were 8, 9, and even 10 per cent. Even though much of the cost of the Union Pacific was borne by the United States, for which a second lien was given, the first mortgage bonds of this road and of the Central Pacific R.R. were issued in 1868 to yield 9 per cent.

Funded debt of American railroads exceeded the amount of stock outstanding for the first time in 1874. In that year, the former was in excess of \$2,000,000,000, while the latter was slightly less than that amount. The average return on typical railroad bonds, by decades from 1860 to 1910, as reported by Moody, was as follows:

Year	Per cent	Year	Per cent
1860	8.58	1890	5.28
1870	7.79	1900	4.23
1880	6.57	1910	4.10

From 1920 to 1940, the ratio of railroad bonds to stock was approximately 12 to 7.

It is interesting to note evidences of a return to railroad financial policies that were common before the 1870's. In recent years, the Interstate Commerce Commission has, on several occasions, called attention to the desirability of railroads looking toward retirement of their bonded indebtedness. For roads that are still solvent, there are very few that are in a position to heed this advice. The pickup in traffic and in earnings as a result of the increased demands for transportation facilities resulting from the Second World War is inducing railroad corporations to use their surplus cash to buy up their bonds which were selling, in many instances, at heavy discounts. In recent reorganizations of railroads, like that of the Erie, for example, new financial plans provide for the issuance of sinking-fund bonds.

**Industrial Experiences.**—Industrial corporations, on the other hand, have generally shown a desire to get out of debt, at least periodically. An

analysis of individual corporations would divide them into two classes. In one group would be put those which intermittently issue bonds when their stocks will not sell to advantage. These bonds, in turn, will be eliminated in some manner as soon as conditions of the money market are favorable. Where industrial corporations fail to put their finances in order so that they can retire their bonds according to this pattern, we find examples of realizations short of expectations. The desire is present nevertheless. In the cases of other industrial corporations, the issuance of bonds under any circumstances is the exception rather than the rule. Such corporations time their financing and their expansion programs in such manner that they are usually able to do their financing through the use of their accumulated earnings and through the sale of stock.

Statistically, at least half of industrial bond issues look forward to their redemption at maturity by providing in their indentures for sinking funds. This ratio is apparently increasing. Short-term issues, in particular, follow the pattern of anticipating repayment at or before maturity. Many such issues are secured only by assets with a relatively short life, and therefore it is not to be expected that they can be easily refunded. It is especially common for industrial corporations with wasting assets to provide in their bond indentures for definite means of using a part of the proceeds from their normal operations to retire their bonded indebtedness.

**Methods of Extinguishing Debt.**—Three methods of debt extinction are available to corporations. Depending upon the bond contract or the consent of the bondholders, all three methods may be available either at or before the due date of the bonds. These methods are as follows:

1. *Redemption.*—By this is meant payment of cash to the bondholders in exchange for the bonds. This may occur at maturity; at any previous date by exercising the corporation's right to call the bonds, if it has such right or acquires it by negotiation; or by purchase of the bonds in the market.

2. *Refunding.*—This means issuing new bonds or other securities to take the place of those outstanding. The purchasers thereof may be existing bondholders, in which case an exchange of bonds takes place; or other investors may buy the new issue, in which case the corporation uses the proceeds from its sale to redeem the bonds outstanding.

3. *Conversion.*—Conversion means the exchange of some other security, usually stock, for the outstanding bonds. Each owner of such securities has the right to decide whether or not he wishes to make the exchange.

**Purposes of Redemption.**—Redemption of bonds at maturity requires no explanation other than to say that by this means the corporation fulfills its obligations to its bondholders. Redemption before maturity gives the corporation some advantage that is not always made a part of the contract. Conditions subsequent to the sale of the bond issue may induce redemption before maturity. Whether the call privilege is exercised or the corporation

acquires the bonds by purchase, it may have one of the following purposes to serve:

1. To eliminate fixed charges. An industrial corporation that experiences alternating periods of large earnings and lean years may find the meeting of fixed charges in periods of little or no earnings very burdensome. In periods of large earnings, the corporation may anticipate the time when its goods or services are not so greatly demanded. It may use its favorable cash position in high-earning years to pay off its debt and thereby to eliminate its fixed charges. If it lacks cash or salable treasury assets whose proceeds may be used for this purpose, it may take advantage of cheap money available from bank loans to borrow money for short periods of time to pay off its bonds. The bank loans may be liquidated, either from future profits or from some subsequent financing operations.

2. To invest idle funds. American corporations, particularly, follow a practice of distributing only a part of their earnings, even in profitable years. Sometimes the earnings that are retained represent idle cash. Even though interest charges on a corporation's bonds may not be either high or burdensome, the redemption of bonds is frequently looked upon as a profitable outlet for idle cash for which the corporation has no immediate or prospective need.

3. To reduce interest charges. Bonds issued in tight money markets are expected to carry high interest charges. In more favorable markets, it is frequently possible to issue bonds with considerably lower interest rates. In anticipation of using lower rate bonds, corporations sometimes call in high-rate bonds and pay them off from treasury cash that may be needed within a few months for other purposes. By the time the need has materialized, the corporation will have replenished its treasury from the sale of a subsequent bond issue carrying a lower rate of interest than the one which has been paid off. The same method of refinancing could be used to replenish the treasury when cash has been used to buy the earlier issue of bonds in the open market.

4. To eliminate bonds with too rigid requirements. Bonds issued in tight money markets not only carry high rates of interest, but they frequently contain unusual obligations that the corporation assumes in order to make the bonds marketable. Investors in times when money is tight are more discriminating than they are when they are more optimistic about the future. As a consequence, those who seek their favor must offer greater inducements than are needed in more normal times. These may take the form of restrictions upon the freedom of operations of the corporation. It is always to the advantage of the issuing corporation to redeem bonds of this character as soon as conditions permit.

5. To provide a more comprehensive and flexible financial plan. When a corporation is first started, or at any rate during its early life before its credit standing is well established, it may be necessary to use a small closed-

bond issue or one containing the after-acquired property clause. Either of these will hamper its future financial operations. The elimination of such bond issues may be necessary to permit greater flexibility and the creation of a more comprehensive financial plan. Curiously enough, the elimination of such bond issues is not always easy. They may not be callable. In such event, they can be eliminated only by bargaining with all the bondholders.

6. To assist refunding operations. Even where the purpose of the corporation is to eliminate one bond issue by exchanging another for it, there are usually some bondholders who do not wish to accept the exchange. When bonds are called for redemption, they must be paid off in cash. Incidentally, if the hope of the corporation is to refund rather than to redeem an outstanding bond issue, the necessity for paying off a considerable part of the existing issue in cash may become quite embarrassing unless there is a ready market for the bonds of the new issue.

7. To provide investments for sinking funds. This process will be described later in this chapter.

8. To sustain a weak bond market. When a corporation finds the market for its outstanding bonds disappearing, it may lose the confidence of its remaining bondholders who will be inclined to offer their bonds for sale merely because they see the price declining without understanding why. Persistent and continuous declines of bond prices may adversely affect the general credit of the corporation. If the causes for the decline in the market for the bonds are likely to have only temporary effect or if the decline is without logical justification, it may be desirable for the corporation to enter the market and buy up enough of its bonds to strengthen the market for them. Purchase of some bonds in the open market may serve to strengthen the whole market for the issue and to sustain or to restore confidence in the financial strength of the corporation. Of course if the decline is in keeping with the general pattern of the security market—and particularly if it promises to be of considerable duration—it may be beyond the capacity of any individual corporation to stem the tide even by engaging in open-market purchasing.

**Redemption Funds.**—If a corporation plans to retire its bonds by redemption, it must have on hand funds for that purpose as and when needed. Presumably these funds come from earnings. Since the burden of redemption is usually too great to be borne by the earnings of the year in which the entire bond issue matures, collection of funds must be anticipated years in advance. Not only must the funds be collected, but they must be impounded for the specific purpose for which they are intended. In correlating collection of funds and redemption of bonds, a corporation may follow either one of two policies: the use of serial bonds or the use of sinking funds. Any other practice would result in some form of bond extinction other than redemption.

**Sinking-fund Bonds.**—Since a corporation can scarcely hope to retire an entire bond issue from the earnings of any one year, there has grown up the practice of issuing sinking-fund bonds. Supposedly the funds for the retirement of such bonds will be built up over a series of years without placing too great a burden upon the financial operations of the debtor. Sinking-fund bonds are favored by many as the most flexible means of assisting corporations to pay off their bonds. The very flexibility that is lauded, however, invites practices that defeat the purpose of the sinking fund. It is not unusual for the sinking-fund principles that are contended for to be violated when they are applied to a specific bond issue. Because of these violations, sinking-fund bonds are often surrounded with confusion and misunderstanding in the minds of the investors. Both principles and practices will be discussed in the pages that follow.

**Meaning of Bond Sinking Fund.**—A bond sinking fund is an amount of money, or its equivalent, set aside for the purpose of providing for the redemption of an issue of bonds at or before maturity. There are two essential reasons for the establishment of a sinking fund. In the first place, the proceeds from the sale of a bond issue are used, presumably, to purchase or to construct productive assets. Whatever the nature of these assets, it is to be expected that they will decline in value, probably progressively over the years, whether they are used or not. Exceptions of course occur in the case of assets that take the form of natural resources such as a mine. Here the decline in value is more definitely related to the exploitation of the resources. In the second place, since there is a due date on the bonds, it is frequently expected that they shall be redeemed as of that date, if not earlier. If the corporation is opposed to a policy of having a permanent debt and looks forward to the time when it will have no fixed charges to meet, then it must provide the funds with which to redeem its debt. These are the two most essential reasons for the building up of a sinking fund.

A third reason for the use of a sinking fund is psychological. Bondholders look forward to the time when they expect to get their money back. Even though they might be content to keep their funds invested in a particular bond issue, they look upon themselves as lenders to the corporation and not as owners of it. They like to experience the comforting feeling that the corporation is able to meet all its obligations, including the payment of its bonds at maturity. For that reason, sinking-fund bonds possess a market appeal that is reflected in their higher price and lower yield. The presence of a sinking-fund clause in the bond indenture and of "sinking fund" as a part of the bond name adds an element of security for which the bondholder is willing to pay a price. Most bondholders do not know the exact nature of the sinking-fund provisions. Neither do they look forward to the time when their corporation may find it necessary to seek relief from

sinking-fund requirements. Nevertheless, the average bondholder feels that sinking-fund bonds are safer than others.

In order to remove the temptation for boards of directors to "borrow" from this fund for other purposes, it should be taken out of the control of such board and placed in the hands of outside trustees who are held accountable only for the purpose that the fund is to serve. The amount to be set aside annually should be definitely related to the purpose of the fund and should be so timed and measured that it will be available when needed and in the amount needed. The money turned over to the trustee should be invested in such form that its ready conversion into cash when needed to redeem the bonds is unquestioned. These constitute the real tests of a sinking fund. Modifications result in pseudo sinking funds, many of which give only lip service to the purposes for which they are intended.

Ordinarily it is expected that the money placed in bond sinking funds shall be reserved by the corporation from its earnings. Occasionally, most unusual circumstances surround the building up of sinking funds. Under the closed noncallable first gold 4½s of the Staten Island Ry. Co., due 1943, there are outstanding \$511,000 of bonds. The trustee holds against these bonds \$670,101, representing the proceeds of awards in condemnation proceedings involving property securing this mortgage taken by the city of New York in 1927.

**Funds vs. Reserves.**—One common mistake in the discussion of sinking funds is to use the term synonymously with reserves. This practice is not only an error, but it is grossly misleading and seems at times intentionally deceptive. A fund is an asset properly earmarked and so impounded that its confusion with other assets is impossible. A reserve, on the other hand, is merely a bookkeeping entry on the equities side of the balance sheet. It is an appropriation of surplus, which is, in turn, a balancing item in the balance sheet, to be discussed in later chapters. A corporation might have ever so large a bond sinking-fund reserve and yet be entirely without funds with which to redeem its bonds. A reserve without a fund merely earmarks a part of surplus and warns against too large dividend distributions. A reserve offsetting a fund issues the same warning; the fund redeems the bonds. When the obligations of the corporation have been reduced with the redemption of the bonds, the stockholders' equity has been changed in form. This may be shown on the balance sheet by a charge to the reserve account and a credit to surplus. Since the bonds have been retired, the bond account will be charged and the sinking fund credited accordingly. The reserve and the fund complement each other. The fund without the reserve may be balanced by unappropriated surplus, and the reserve without the fund is balanced by assets of some kind. Neither procedure, however, is recommended. The reserve without the fund usually results in refunding the bonds, not in redeeming them.

**Effect of Bond Sinking Funds.**—Where bond sinking funds are operated as herein outlined, their effects are various. Among the most important are the following:

1. They increase the price of the bonds by inspiring confidence in the ability of the issuing corporation to redeem them at or before maturity.

2. They act as a check upon the financial policies of the management by requiring the setting aside from cash the amount of the sinking-fund payment before other disposition can be made of cash.

3. Where the sinking fund is invested in the open-market purchase of the bonds to be redeemed, the effect is a stabilization of the market for such bonds at a relatively high level. This protection of investors also improves the credit rating of the corporation.

**Voluntary Sinking Funds.**—A corporation not required by its bond indenture to set up a sinking fund may find it expedient to do so. Such action is commendable and frequently is taken with the best of intentions. But if a board of directors may exercise its discretion in setting up the fund, it may also exercise its discretion in using its contents for purposes other than bond redemption. Such sinking funds are usually the frail children of prosperity: they seldom survive adversity. The Georgia, Southern and Florida Ry. Co. has voluntarily set up a sinking fund for the retirement of its debenture gold 5s. The voluntary payments do not constitute an obligation. The investment of the fund is in charge of the management, which has pursued no formal policy with reference thereto.

**Sinking-fund Morality.**—The week-before-Christmas spirit that infects small boys finds a counterpart in the use of sinking funds by some corporations. When the latter wish to make a good impression upon prospective purchasers of their securities which lack market appeal on their own merits, the issuers sometimes add the appeal of protection, which sinking-fund promises are supposed to supply. Likewise, when a corporation is in financial difficulty and needs the assent of its security holders to the adoption of some plan of reorganization, sinking-fund provisions are sometimes added to certain classes of securities which have theretofore lacked them.

In the reorganization of the corporation that owned the Hotel Taft in New York City, the former bondholders were offered new 4 per cent 15-year first mortgage bonds, dollar for dollar, and scrip certificates for the interest in arrears. The agreement stipulated that one-third of the earnings over the 4 per cent interest charges would be used to retire the scrip certificates, and one-third to retire the new bonds. After the certificates were retired, two-thirds of the earnings over the 4 per cent interest charges would be used to retire the bonds until their aggregate amount was reduced to \$3,000,000. Thereafter one-half of such surplus earnings was to be used for bond retirement.



**Determinants of Sinking-fund Installments.**—Annual sinking-fund installments definitely measured by and related to the purposes the fund is expected to serve produce real sinking funds. Where the payments are optional, in whole or in part, with boards of directors, or where they vary according to any factor other than purpose, they cease to be real sinking funds. Annual sinking-fund payments varying with gross earnings, net earnings, admitted surplus, or dividend disbursements *may* produce the funds necessary to effect bond redemption. On the other hand, they may *not*. In industries with wasting assets, there is more reason perhaps for making sinking-fund installments dependent upon the amount of depletion. Even then such installments may not provide the funds for bond redemption at or before maturity. Such a practice may be financially defensible, but it does not build up a real, effective sinking fund.

The sinking fund of the U.S. Rubber Co. first and refunding 5s and 6s is established at 1 per cent of all such bonds originally issued. It is to be used to purchase series A bonds, not exceeding 105, and series B bonds, not exceeding 110. If no such bonds are purchasable, the company is relieved of its obligation to add to the sinking fund for that year. Additional bonds of these series may be issued for improvements and acquisitions up to three-fourths of their cost. Not more than one-third of additional bonds may be used to purchase other securities up to three-fifths of their cost.

The sinking fund of the gold 5s of the Philadelphia and Reading Coal and Iron Co. is made up of a charge of \$0.05 per ton of anthracite coal mined. The sinking-fund provision of the Erie R.R.-Pennsylvania collateral trust gold 4s, issued in 1901 and due 1951, requires the payment to the trustee of \$0.10 per ton for all coal mined by the Pennsylvania Coal Co. for the purchase or call of bonds at not over 105. Bonds so acquired are kept alive, and interest thereon is added to the fund.

The debenture 5s of the United Biscuit Co. provide that the company retire annually, by purchase or redemption, 3 per cent of the entire issue of debentures, regardless of earnings; 4 per cent, if the earnings applicable to dividends are at least \$1,200,000 but less than \$1,500,000; and 5 per cent, if such earnings exceed \$1,500,000.

**Other Purposes of Bond Sinking Funds.**—Some so-called “bond sinking funds” are apparently not intended to provide completely and solely for the redemption of a bond issue. They may be intended in part as a cache in which to hide earnings: annual payments increase with increases in earnings. They may not be intended to extinguish the debt completely: the board of directors merely makes a gesture in that direction. They may be intended to add protection to the bondholders whenever the stockholders are well treated: sinking-fund payments may be related to dividends distributed. Sinking funds may be looked upon as unfair burdens on the corporation:

annual payments may be related to gross or net earnings. If the corporation sells little or earns little, it sets aside little in sinking funds.

All these and many other questions are matters of financial policy, to be given careful consideration. But they do not meet the test of true bond sinking funds unless they provide the funds with which to redeem the bonds.

**Investment of Sinking Funds.**—Assuming that adequate amounts have been set aside from earnings of each year to provide a true sinking fund, and that the funds for this purpose have been turned over to a trustee to avoid the temptation of letting corporation directors use the funds for some other purpose, however legitimate, the next question that arises is, how shall the sinking fund be invested? In answer to this question, there are three tests to be employed as follows:

1. *Security.*—The trustee dares not take too much risk in the investment of sinking funds. A gain in principal is quite unnecessary, for the trustee has in mind a definite purpose whose fulfillment requires a predetermined amount of money. A loss in the invested principal is to be avoided if possible, since it would tend to weaken the principle of the bond sinking fund. If the sinking fund is to operate as intended, the trustee must be able, upon the conversion of his investments into cash, to realize enough to pay the face value of the bonds to be redeemed.

2. *Income.*—With respect to the earnings upon the sinking fund, the trustee faces a difficult task. It would be poor business, for instance, for a corporation to be paying 5 per cent interest to its bondholders at the same time that the trustee was earning only 3 per cent on the sinking fund that is being built up to retire the bonds. Meantime, however, in his efforts to find investments that will yield a rate comparable to that paid on the bonds, the trustee must not sacrifice security.

3. *Liquidity.*—In his investment program the trustee is further limited by the necessity for liquidity of his investments. At the maturity date of the bonds, or perhaps even before that date, the trustee must be able to convert his sinking-fund investments into cash, in order to have the money with which to redeem the bonds. This means that marketability, as well as the security and the income of sinking-fund investments, must be kept in mind by the trustee.

**The Ideal Investment.**—With the above tests in mind, the ideal investment for a bond sinking fund is the bond issue that the sinking fund is intended to redeem. No other investment, or combination of investments, will come so near to meeting these tests. If the bonds can be purchased in the open market at or near their face value, whatever happens to their price thereafter is a matter of indifference to the trustee. The fact that they are being purchased regularly by the trustee should tend to hold up the price. This is desirable from the point of view both of the bondholder and of the

corporation. Unless the corporation gave them, at the time of issue, high interest rates or other attributes that put them out of line with other similar investments, they are not likely to sell for much more than their face value. The nearer they approach maturity, the time when the purchases by the trustee would have the greatest psychological effects upon the investing public, the greater will become the pressure of maturity in keeping down the price.

While the regular purchase of the corporation's own bonds may be an ideal investment for the sinking fund, it may not be so desirable for those bondholders whose bonds are purchased last. Marketability may be taken from the remaining bonds after most of them have been purchased for the bond sinking fund, while both principal and income are assured of greater security. Marketability depends upon an active and a broad market which is conditioned by the existence of a relatively large amount outstanding. A bond issue that enjoys a satisfactory market when there are \$1,000,000 of bonds outstanding would probably lose the interest of most bond purchasers when the issue has been reduced to \$100,000. Certainly for the bondholder who has little interest in marketability, the perfect operation of a sinking fund that purchases the corporation's own bonds gains materially from the purchases made by the trustee—until it comes his turn to respond to a call for the redemption of his bonds.

**Methods of Purchasing Bonds.**—When either the corporation or the trustees pursue a policy of using money in a bond sinking fund to buy up the bonds, there are several purchase methods that are available. If the bonds are callable, this is perhaps the simplest method to follow. The call price sometimes allows some premium to the bondholder. If they are listed on some exchange, they may be purchased in the open market. In such case, purchases may not always be made regularly as the funds are accumulated because the market price may be too high. The maximum amount that can be paid for the bonds is usually fixed in the agreement. This maximum may be less than the market price. For example, the Public Service Corp. of New Jersey provided an annual sinking fund for the purchase of one class of 6 per cent bonds. The fund was to be used for the purchase of the bonds at not more than 110. In 1935 the low price of these bonds was 118, and in 1936 the low price was 132¾.

It is always possible for the corporation to ask its bondholders to offer their bonds for sale on tenders, either at a price fixed by the corporation or on invitation for the bondholder to set an "asking" price. Even when asking prices are solicited, the corporation usually names a maximum figure that it will pay. The maximum tends to guide the bondholder in fixing his price. The Capital City Hotel Co., Inc. used its sinking fund to buy its first mortgage 6½ per cent gold bonds "at the lowest price not in excess of the principal." In 1937, the trustee for the sinking fund of the 6½ per cent first

mortgage gold bonds of the Atlantic Beach Bridge Corp., due 1942, invited tenders of these bonds at prices not to exceed 103.

**Sinking Funds and Improvements.**—In some sinking-fund bond indentures, there is a provision that permits boards of directors to use, for improvements to the property, funds that would otherwise be added to the sinking fund. In other words, money invested in additions, betterments, and improvements is considered an adequate substitute for a sinking fund. Proponents of such a policy defend it upon two grounds: (1) From the point of view of the corporation, such funds constitute a ready source of new capital without incurring additional costs for carrying charges. (2) From the point of view of the bondholders, they receive adequate protection in the form of a commensurate increase in the corporation's assets. Even if we take both of these statements at their face value, there are still questions to be raised about them. In the first place, we would need to invoke the after-acquired clause to make sure that the bondholders get the full benefit of the added protection. Then we must assume that the amount of value added by the improvements would at least offset the effects of depreciation and obsolescence of existing properties covered by the bond issue.

Such an analysis leaves two objections to the policy of substituting investments in improvements for additions to the sinking fund. In the first place, there is always the question of what constitutes improvements. There is always the possibility of confusing repairs and replacements with betterments and improvements. The former do not constitute additions to capital. Only a part of the latter may be so classified if the betterment, for example, is also, in part, a replacement. If the accounting procedures are left to the determination of boards of directors, as would usually be the case, what is classified as an addition to the capital may be in the nature of its maintenance instead. At least a competent trustee for the sinking fund should be given the discretion of determining where to draw the line between improvements and other changes in the capital of the corporation. In the second place, even the maintenance or the increase of the value of the assets protecting a particular bond issue will not provide for the redemption of the bonds when they fall due. Even though the reinvestment of the corporation's net earnings in additions and betterments is profitable, the maturity date of the bonds may find the corporation without funds to meet its obligations. Under favorable circumstances, such a reinvestment policy will justify the hope of refunding rather than of redeeming an existing bond issue. Under less favorable conditions, both the corporation and the bondholders may face serious embarrassment because there are insufficient amounts in the sinking fund to redeem the bonds at maturity.

There are many illustrations of sinking-fund provisions that contemplate the substitution of investment in improvements for additions to the sinking fund. The following are typical: The sinking-fund provision of the first

and refunding gold 4s of the Delaware and Hudson Co. permits the company to apply the 1 per cent per year sinking fund to the purchase of bonds or to construction, additions, etc., to be placed under the lien of the mortgage. The railroad and land-grant first gold 4s of the Union Pacific R.R. Co. constitute a first lien on specified railroad property and the company's land grants. Net proceeds from the sale of lands and of securities pledged under this mortgage are held by the trustee for financing improvements.

**Sinking Funds and Taxation.**—Much discussion has been indulged in in recent years concerning the paucity of "equity" capital invested in American corporations in comparison with the ample supply of "debt" capital. The implications of such discussion usually point to a public policy that favors encouragement of less dependence upon borrowing. Yet in some of our tax laws we discourage the systematic elimination of debts. For example, in the Federal Revenue Act of 1936, the much discussed undistributed-profits tax tended to penalize the use of sinking funds in favor of the payment of dividends to the stockholders. Profits that were distributed to stockholders in the form of cash dividends were not taxed. Money added to bond sinking funds was taxed since this represented "undistributed" profits. The following prophetic quotation from a leading investment banker emphasizing the importance of the bond sinking funds is significant. "After all, while the undistributed profits tax in its present form may well prove to be only a temporary difficulty, the need for providing for periodic and substantial reductions in funded debt is permanent."<sup>1</sup>

**Informal Waiver of Sinking Funds.**—The development of the subject of sinking funds thus far has tended to emphasize their rigidity. This has been intentional. Alternative plans of retiring corporate debt other than redemption are discussed in the following chapter. In the current chapter, an effort has been made to show what must be done if the debt is actually to be redeemed through the operation of a sinking fund. In placing this emphasis upon rigidity of sinking-fund procedures, it is recognized that strict adherence to their requirements may place heavy burdens upon the corporation's financial policies at times of small profits or even losses from operation. With the best of intentions, corporate officials sometimes find themselves in a position where they must seek relief from the rigidities of sinking-fund requirements. The procedure to obtain relief follows several successive steps. At the outset, it is generally believed that the emergency will soon pass and that a deferment in adding to the sinking fund can do no harm.

If the board of directors manage the sinking fund, probably no one except the insiders will be aware that the usual sinking-fund installment has not been met. If an independent trustee manages the fund, he should know of any default in the payment of expected installments. If he does know, presumably he will at least enter a protest when the default occurs. Beyond

<sup>1</sup> *Proceedings I.B.A.*, 1936, p. 57.

the use of whatever pressure he can bring upon the corporate management to make good the omission of the payment, the trustee is frequently perplexed as to the procedure that he should follow. If the interest on the bonds is being paid, the bondholders will not know about the default in sinking-fund installments and consequently will not be disturbed because of it. The trustee might notify them of the default. To do so might create alarm among them and, in addition, might unduly weaken the general credit standing of the corporation.

Since failure of the corporation to pay regular installments into the sinking fund frequently constitutes a breach of contract, the trustee could appeal to a court of equity to enforce the contract. Bringing of such a suit would undoubtedly have a distinctly adverse effect upon the credit of the corporation. It would probably result in the appointment of a receiver. Even then, there is no assurance that the defaulted sinking-fund installment would be paid. The court might well conclude that conservation of the assets of the corporation is more important than fulfilling the rigid requirements of any sinking-fund provision in a bond indenture. Hence, it is not clear that the trustee should always exhaust every means at his disposal in his efforts to enforce to the letter the sinking-fund requirements under which he operates. Even the interests of the bondholders might be better served if the trustee winks at a default in this section of the bond indenture, at least temporarily, if it appears that the conditions which prompt the inaction of the board of directors are beyond their control.

Another factor frequently prevents a trustee from taking positive action in case a corporation defaults in its obligations to make additions to sinking funds. Sinking-fund clauses in bond indentures are so worded that it is assumed that they will be observed and not violated. Even the most carefully phrased clauses fail to provide proper penalties. They do not even provide the necessary funds for their administration. It is not surprising that trustees hesitate to use their own funds to attempt to enforce compliance. They can and do often write polite letters and some that may not be quite so polite. Meantime, the sinking-fund provisions are frequently ignored, modified, or abandoned, with or without the knowledge or the reluctant consent of the bondholders.

**Formal Waiver.**—Eventually, if corporate managements continue to be unable to meet sinking-fund requirements of their bond issues, it is expected that they will make formal request for a modification of the rigidities of the contract. These modifications usually consist of complete relief from the payment of past-due installments and either temporary or permanent waiving of future payments. In return for such waivers the bondholders will usually be given some other advantage. A few illustrations will show the character of these advantages. For the years 1933–1935, the directors of the New York Trap Rock Corp. failed to meet the sinking-fund requirements

on their 7 per cent sinking-fund gold debentures. In 1936 the corporation secured the approval of the bondholders for the waiver of sinking-fund requirements for the three preceding years and for the extension of the maturity date of the bonds from 1936 to 1946. In return, the debenture bonds were given mortgage security. The rate of interest for the period of the extension was reduced to 5 per cent with the right to participate, on a par with preferred stockholders, in future profits to the extent of 1 per cent per year cumulative. Any unpaid accumulation is payable, in addition to unpaid interest and the face value of the bonds plus a premium of 5 per cent, in case the bonds are redeemed before maturity.

In return for a temporary waiver of sinking-fund requirements on its bonds, the Manati Sugar Co. agreed not to pay any dividends on its stock until all bond sinking-fund arrearages were made up. In 1933, the holders of the first mortgage bonds of the California Cotton Mills Co. agreed to waive sinking-fund requirements for the next three years. Meantime, to give the bondholders better opportunity to be kept informed about the affairs of the corporation, they were permitted to elect one member of the board of directors for this period of time.

Most requests for waivers of sinking fund requirements are presented in periods of economic depression when bondholders expect less than their contracts entitle them to receive. If they are permitted to receive the interest payments as usual, it is not difficult to secure their consent to a sinking-fund waiver. For the most part, they recognize their helplessness and see that they have no alternative but to acquiesce, actively or passively, in the change in their contracts. The same feeling of helplessness prevents them from taking action against the corporation that fails to make sinking-fund payments but that also fails to ask for formal waiver from the bondholders.

**The Sinking-fund Paradox.**—In a very real sense, sinking-fund provisions in the indentures of bonds and preferred stocks present a paradox. If the corporation's financial success is sufficiently marked to permit it to live up to the strict requirements of a true sinking fund, the probabilities are that the holders of the securities whose retirement is being assured by the sinking fund would prefer to retain their investment. If, on the other hand, the corporation is unsuccessful, its security holders would be glad to have the protection of a sinking fund.

**Aids to Sinking Funds.**—Occasionally, a corporation will use a part of its profits in good years to make payments into sinking funds that are larger than those called for in the bond indenture. In this manner, it anticipates lean years and makes its sinking-fund payments in advance. This practice is certainly an aid to the sinking fund. In like manner, profits may be used to retire bond issues whose lien on the corporation's assets is prior to that of the bonds bearing the sinking-fund requirements. Sometimes these prior-

One ingenious type of serial bond provided that all outstanding bonds should be amortized over a series of years. The New York Glucose Co. issued \$2,500,000 of bonds in 1902 to construct a new plant. Warrants were attached to each bond giving the holder the right to the repayment of 4 per cent of the principal amount of the bond at the end of each year for the life of the bonds. By this means only 1½ per cent of the original face value of the bond remained unpaid when the bonds matured 25 years after their issuance. This kind of bond issue seems to have considerable to commend it, both from the standpoint of the corporation and of the investor. Yet so far as the records show, it has not created a strong appeal to either group.

**Serial vs. Sinking-fund Bonds.**—Serial bonds have frequently been compared with sinking-fund bonds. The differences may be so slight that the operation of a sinking fund may practically parallel the maturity of serial bonds. In fact, the logic of a perfect sinking-fund bond indenture recommends that the serial bond be used instead. Sinking-fund bonds, on the other hand, may give the appearance of being as safe for the investor as serial bonds, but without actually affording the protection promised. As already noted, sinking-fund bond indentures afford greater flexibility than those which establish the rights and obligations of serial bonds. This flexibility may not be an unmixed blessing for either the bondholder or the corporation. It may lead to financial carelessness which will affect the best interests of both adversely.

Aside from the legal rights established under either kind of bond indenture, there is certainly a marked difference in administering the retirement of the two kinds of bonds. We have noted that bondholders frequently do not know of defaults in sinking-fund administration for some years after the defaults occur. No single bondholder could do anything about it if he was aware of the default. Even trustees are powerless to take effective action, as we have pointed out. On the other hand, each holder of a bond in a maturing series is an enforcement officer. If his bond is not paid at its maturity date, he knows about it and is much more likely to do something to protect his interests. He is not inclined to continue to hold a matured security, whose right even to future income is nil, without taking the trouble to see what is happening and what remedies are available to him.

As a choice between a sinking-fund bond which actually provides for the redemption of a bond issue at its maturity and a serial bond issue, both the investor and the corporation are better served by the use of the latter. It enjoys all the advantages with none of the disadvantages of the former. To be sure, sinking funds may be increased in good earning years as a means of offsetting the obligations of the corporation in lean years. But sinking funds may be set up in the same manner to retire serial bonds that mature in lean years. Sinking funds may be used to buy bonds in the open market, thereby sometimes enabling the corporation to retire its indebtedness at less



than its face value and at the same time providing a market for those bondholders who wish to sell. The same can be said of serial bonds which can also be purchased in the open market. In other words, every argument that can be made for sinking-fund bonds that really provide for the redemption of the bonds can be used in favor of serial bonds. In addition, serial bonds possess advantages, already described, that are not present in the use of sinking-fund bonds.

### QUESTIONS AND SUGGESTIONS

1. Do all corporations expect to reduce their outstanding debt when a bond issue matures? Explain.
2. How do railroads differ from industrials in their debt-extinction practices?
3. What proportion of industrial bonds carry sinking-fund provisions?
4. What methods of extinguishing debt are available to corporations?
5. List the purposes of redeeming bonds before maturity.
6. What are the possible sources of funds for the redemption of bonds?
7. What are sinking-fund bonds? What are the reasons for building up a sinking fund? How should sinking funds be administered? Why?
8. Differentiate between a reserve and a fund. What are the effects of a bond sinking fund?
9. What may determine the size of annual installments set aside in the sinking fund? Which do you recommend? Why?
10. In the investment of sinking funds, what tests should be used? What is the ideal investment for sinking funds?
11. What methods may be used to purchase bonds for sinking funds?
12. Are funds invested in additions and betterments adequate substitutes for a sinking fund? Explain.
13. How may tax laws influence the operation of a sinking fund?
14. What is an informal waiver of sinking-fund payments? Who knows about it? What is a formal waiver? How is it obtained?
15. What are the remedies of bondholders who object to a waiver of sinking-fund payments?
16. What kinds of advantages are sometimes traded to bondholders in return for a sinking-fund waiver?
17. What kinds of aids to sinking funds are sometimes used?
18. How do serial bonds differ from sinking-fund bonds? How can a corporation with serial bonds outstanding meet its bond requirements in lean years?
19. As a corporate official, would you prefer a sinking-fund bond or a serial-bond issue? As an investor, would your answer be the same? Explain.

### SUPPLEMENTARY READINGS

See end of Chap. XV.

### SUBJECTS FOR INVESTIGATION

1. From a recent edition of any manual, find five sinking-fund bonds. Which of the corporations that issued these bonds carry sinking-fund reserves on their balance sheets? Are the sinking funds adequate for the purpose of retiring the bonds at maturity?
2. With respect to any one of the above bonds, suggest five specific kinds of investment for the sinking fund and tell which one you recommend. Why?
3. Find five examples of serial bonds.

## CHAPTER XV

### EXTINCTION OF INDEBTEDNESS

*(Concluded)*

**Refunding.**—It was pointed out in the preceding chapter that corporations differ in their attitude toward debt. Some try to pay off their debts as quickly as circumstances permit. Others apparently do not fear a permanent debt. Whatever be the maturity of the bonds outstanding, in effect the corporation that has no plan for the retirement of its debt usually continues its indebtedness in some form. When one bond issue matures or is called for redemption before maturity, it is frequently paid off from the proceeds of the sale of another security issue. This process is known as “refunding.” The new security may take the form of other bonds or shorter term notes. In other words, when a bond issue is refunded, the new bonds may be quite different from those which are retired. The differences may represent, in part, the changes in desires of the corporate management; in part, they may reflect the demands of the investors who acquire the new securities.

**Extended Bonds.**—In some cases the corporation has no alternative but to extend outstanding bonds at their maturity date. When this happens, the bondholders usually have no practical alternative but to submit to the extension. When outstanding bonds fall due at periods of unfavorable money markets, the issuing corporation may not be able either to pay them off or to sell a new issue of bonds to replace them. The result is forced refunding by the present holders in the form of an extension agreement, which may or may not make changes in the existing contract. Depending upon the terms of the bond indenture, dissenters may succeed in obtaining cash for their bonds, provided that a sufficient majority of the bonds are extended. Bond-extension agreements are frequently approved by bondholders even before their maturity date. Taking advantage of tight money markets and the prevailing investment pessimism that accompanies them, corporations sometimes prevail upon their bondholders to approve an extension even though the maturity date may still be some years in the future.

It is not uncommon for bonds that have once been extended to be extended again when the second maturity date arrives. The New York and Erie R.R. Co.'s second gold 7s, issued in 1849, were extended at maturity in 1859 to 1864, then to 1879, then to 1919, then to 1939. With

the last extension, interest was reduced to 5 per cent. The Johnstown, Gloversville and Kingsboro Horse R.R. first 5s, due in 1913, were first extended to 1933. On the latter date they were extended indefinitely. Under a supplementary agreement, the lessee agreed to establish a sinking fund to provide for their retirement.

If the bondholders are sufficiently pessimistic at the time extensions of maturity are granted, they will probably be asked to approve reductions in interest rates also, either temporarily or permanently. On the other hand, the modifications made in the contract may favor the bondholders. When the first mortgage gold 6s of the Oregon Pulp and Paper Co. were extended from 1936 to serial maturity from 1937 to 1945, the interest rate was increased from 6 to 6½ per cent. Incidentally, holders of more than 99 per cent of the bonds consented to the extension. Since the bonds not so classified amounted to only \$3,000, the corporation stopped interest payments on this amount, expecting to pay them off when they were presented for redemption.

**Refunding at Maturity.**—The managers of a corporation may consider continuation of its debt evidence of sound financial policy. Finding the practice of trading on the equity profitable, they may desire to continue it. In following such a policy, the management faces the possibility that, when its bonds fall due, its earnings may be so low that it will have difficulty in refinancing its debt. Or, due to tight money markets, the corporation may face a situation that makes refunding difficult, whatever the condition of its own finances. The longer the term of a particular bond issue, the greater the uncertainty of financial conditions, external and internal, at its maturity. As a consequence, some bonds may be refunded under very favorable circumstances, with lower interest rates and other terms of the new issue more to the liking of the corporation management than were those of the old issue. On the other hand, conditions may be so unfavorable at the time of refunding that the corporation suffers the penalty of having the bondholders dictate the terms of the new issue, involving higher interest rates, better security, etc.

Some corporation managements do not look upon bondholders as creditors. Instead they are considered as preferred participants in the fortunes of the enterprise. While they have a claim to fixed charges each year, nevertheless their investment is looked upon as permanent. When the nominal due date of their bonds arrives, they are asked to accept a new issue of bonds in place of the old. In fact, most successful refunding operations result in an exchange of bonds. Unless the holders of a large proportion of the old issue agree to accept the new bonds in exchange, the refunding operation may not succeed. Refunding a bond issue at maturity does not necessarily mean the sale of the new issue to a new set of bondholders. The minority of old bondholders who prefer cash to the new

bonds can be paid off, provided their aggregate claims are not great. They can be paid from the proceeds of the sale of their portion of the new bonds. If most of the present holders are willing to accept the new bonds, there will be relatively little difficulty in disposing of the part not exchanged.

In recent years, the dependence of the corporation upon the acceptance of new bonds by the old bondholder has not been so general as formerly. Particularly when private subscriptions to bond issues are resorted to, the old bondholders may not even be given an opportunity to purchase bonds of the new issue. They are simply paid off from the proceeds of a new issue of bonds sold to a single purchaser or a small number of purchasers such as insurance companies or other large institutional investors.

In other instances, the refunding of a bond issue at its maturity is made necessary because the corporation management has made no plans, either for redemption or for refunding. They simply lack the money with which to redeem the maturing bonds. They have no alternative but to refund them. Under such circumstances, the bondholders may find an element of coercion in accepting bonds of the new issue. Perhaps against their wishes they may decide to accept the new bonds because there is no other practical alternative. As in the case of agreeing to an extension of the old bonds, the holders of the old issue may insist upon changes in the contract before accepting bonds of the new issue.

**Refunding before Maturity.**—On the theory that corporation management should have considerable leeway in their ability to redeem bonds before their maturity date, most bonds issued in recent years contain the call privilege. In practice, this right of redemption on call has frequently resulted not in retirement of the bonded indebtedness of the corporation but in a change in its form. In other words, the call privilege is frequently exercised at a time when the management wishes to refund a bond issue before its maturity date. The call privilege gives the management a distinct advantage over the bondholder who might wish to retain his present investment. As an offset to this advantage, the bondholder is usually given a premium when his bond is called. The amount of the premium constantly declines as the bond approaches maturity, when it disappears entirely.

Refunding of a bond issue before its maturity date may accomplish one or more of several purposes. Among the most common are the following:

1. *Reduction of Fixed Charges.*—Bonds that are issued during periods of tight money markets bear correspondingly high rates of interest. Whatever the reason for the issue, investors are likely to take advantage of their favorable bargaining position and refuse to accept bonds that do not bear high interest rates. When more favorable money markets produce lower interest rates, it is to be expected that bonds with unusually high interest rates will be called and in their place will be substituted those with lower carrying charges. The following illustrations are random samples of

refunding practices whose chief objective was a reduction in interest rates. A study of the table will show that in some instances other changes were made also.

Name of company	Kind of bonds retired	Interest rate	Kind of bonds issued	Interest rate
A. E. Staley Manufacturing Co.	First mortgage	6	First mortgage	4
Crown Cork and Seal Co.....	First mortgage	6	First mortgage	4
Emporium Capwell Co. . . . .	Debenture	5½	sinking fund	
L. C. Smith and Corona Type-			First mortgage*	4
writers, Inc. . . . .	First mortgage	6		
Memphis Com'l Appeal Co. ....	Debenture	6½	Serial debenture	Variable
			Sinking fund de-	4½
			benture	
Otis Steel Co. . . . .	First mortgage	6	First mortgage	4½
			sinking fund	
Penn Glass-Sand Corp.....	First mortgage	6	First mortgage	4½
Revere Copper and Brass, Inc..	First mortgage	6	First mortgage	4¼
	sinking fund		sinking fund	
Scott Paper Co.....	First mortgage†	6	Convertible de-	3¼
			benture	
Sharon Steel Corp.....	First mortgage	5½	Convertible de-	4½
			benture	
Simmons Co.....	Serial debenture	5	Convertible de-	4
			benture	
Sun Oil Co.....	Debenture	3¾	Serial debenture	2¾
Weyenberg Shoe Mfg. Co.....	Notes	7	Convertible de-	4½
			benture	
Wilson and Co., Inc.....	First mortgage	6	First mortgage	4
Youngstown Sheet and Tube Co.	First mortgage	5	First mortgage	3½
			convertible de-	
			benture	

\* Parent company.

† Subsidiary.

2. *Anticipation of Maturity.*—A corporation may take advantage of a favorable money market a short time, perhaps a year or two, before the maturity date of a bond issue by arranging for the refunding of the outstanding issue. Money rates and financial conditions in the current market are known. Those which will prevail in the future are only subject to conjecture. A refunding operation in the current market will at least give the corporation an opportunity to make a favorable shift in the form of its bonded debt. Whether it would gain or lose by waiting until maturity before refunding its bonds is uncertain. The certainty is accepted as preferable to the uncertainty.

3. *An Aid to New Financing.*—When a small closed bond issue, or one with the after-acquired property clause, stands in the way of a corporation's

comprehensive financial program, it may be eliminated by a refunding process if the bonds outstanding are callable. The new bond issue may be much larger than the old one, and it may serve other purposes than refunding. Indeed many refunding issues are designated in such manner as to indicate their dual or multiple purpose. A good illustration of an issue that eliminated smaller issues is the  $3\frac{1}{4}$  per cent first and refunding 30-year bond issue of the Philadelphia Electric Co. The proceeds of this \$130,000,000 issue were used to refund \$1,671,700 4s of 1966; \$37,000,000 5s of 1966; \$31,990,000  $4\frac{1}{2}$ s of 1967; \$1,323,000 Suburban Gas Co. 5s of 1952; \$18,398,000 Philadelphia and Suburban Gas and Electric Co.  $4\frac{1}{2}$ s of 1957; and \$40,000,000 4s of 1971. The American Telephone and Telegraph Co. had issued no new securities to obtain money for new capital for some years prior to 1936. Reduced plant expenditures and adequacy of treasury funds had made such new financing unnecessary. But with the cheap money markets available in 1936 and 1937, this corporation did a great deal of refunding of its outstanding bonds in order to consolidate some of its smaller issues and to gain the advantages of cheaper money. During these two years, it refunded 5 per cent bonds and debentures aggregating \$332,850,000, using one 25-year  $3\frac{1}{4}$  per cent debenture issue of \$175,000,000 and one 30-year  $3\frac{1}{4}$  per cent debenture issue of \$160,000,000 for the purpose. In addition, it substituted  $3\frac{1}{4}$  per cent interest for 5 in refunding \$55,000,000 of subsidiary bonds. Subsequently, in 1946, \$125,000,000 of the bonds issued in 1936 and 1937 were in turn refunded into 40-year debentures bearing an effective interest rate of 2.59 per cent.

The experience of the American Telephone and Telegraph Co. in using the cheap money markets of 1936 and 1937 to refund its outstanding higher rate bonds was duplicated in many other American corporations. For the year 1936, the industrial securities committee of the Investment Bankers Association of America estimated that less than a third of the funds raised by public offerings of securities of industrial corporations were used for the purpose of providing new capital. The remainder was used for refunding purposes.<sup>1</sup> Bonds of public utility corporations called during the middle thirties before their maturity were considerably greater in amount than those refunded by industrial corporations. Railroads called much less than either public utilities or industrials. Two reasons accounted for this: railroad bonds less frequently contain the call privilege; and more important, the weakened position of railroad finance prevented railroad corporations from taking full advantage of the cheap money markets prevailing at that time.

For all corporation financing reported by the *Commercial and Financial Chronicle* for the year 1936, refunding accounted for nearly three-fourths of security issues of that year. This compares with approximately one-eighth of all issues floated in 1929 for refunding purposes. For the decade

<sup>1</sup> *Proceedings I.B.A.*, 1936, pp. 48-58.

of the 1920's, only about one-fifth of all securities issued were for refunding purposes; during the decade of the 1930's two-thirds of all securities issued were for refunding.

As a result of the war prosperity enjoyed by American railroads during the early 1940's, those companies whose bonds were callable and whose improved credit standing warranted the change refunded many bond issues to take advantage of prevailing low interest rates. Some indeed used successive refunding operations when their first effort in this direction produced a higher rate of interest than was justified by prevailing market requirements. The Securities and Exchange Commission reported for its fiscal year ended June 30, 1945, that the net proceeds of all corporate securities offered for sale during the year was \$4,071,648,000, of which \$3,293,467,000, or 80.9 per cent, was used to retire bonds, other debt, and preferred stock. Railroads and public utilities issued practically no securities for new capital purposes, while about half of the offerings of industrial corporations were for refunding purposes.

**Attitude of Bondholders.**—When a corporation reserves the right to call its bonds before maturity, the bondholders have no choice but to present their bonds for redemption upon call. Even here, however, when the corporation expects to use the call privilege for the purpose of refunding a bond issue before its maturity, it may depend upon the present holders of its bonds to accept in exchange for them most of the new issue. In such case, if present bondholders fail to accept such exchange, the probability of successful disposition of the new issue is not great. When a corporation wishes to refund before maturity a bond issue that lacks the call privilege, it must bargain with its bondholders to induce them either to accept new bonds in place of the old or to accept cash for their bonds before the maturity date has arrived. In either event, therefore, the attitude of the bondholders toward the refunding process is a subject for careful consideration by the management of the corporation. The most common inducements used by a corporation in its negotiations with its bondholders who are asked to accept new bonds for old ones are the following:

1. *Partial Redemption.*—Bondholders who consider themselves creditors of the corporation like to feel that they can get at least part of their money back if they want it. For that reason, corporations frequently offer to each bondholder a choice of receiving new bonds for old, par for par, or part cash and part bonds of the new issue.

2. *Cash Bonus.*—The exchange of bonds is sometimes "sweetened" with a small cash bonus. This may simply mean a slightly larger premium than is provided in the bond indenture. The savings to the corporation are expected to more than justify it.

3. *Higher Interest Rate.*—Where considerations other than the reductions in costs motivate corporate managements, they may offer an interest rate on

the new bonds that is higher than that on the old. Or the corporation may assume some of the income tax burdens of the bondholder, thus increasing his net return on the bonds.

4. *Sinking Fund*.—A common inducement offered is the provision of a sinking fund for the retirement of the new bonds to be exchanged for an issue which lacks this feature. Since most bondholders are willing to pay something for sinking-fund protection, the addition of this provision may induce the exchange.

5. *Wider Market*.—A large bond issue usually possesses a wider market than a small issue. Where the refunding issue is large and takes the place of several smaller issues, bondholders may gain sufficient marketability to justify the exchange.

6. *Better Security*.—Many large refunding issues are better secured than some small underlying bond issues not possessing the advantage of the after-acquired property clause. On the other hand, many closed small issues possess greater security than can be afforded by one large blanket issue.

7. *Guarantee*.—Parent companies sometimes guarantee refunding bond issues that absorb small issues which have no such guarantee.

In the refunding of any particular bond issue before its maturity date, a corporation may offer a combination of two or more of the above advantages to its bondholders as an inducement to secure their acceptance of the new bonds. The management cannot well "auction off" the new bonds, adding such features as it finds from the response of the bondholders or lack of it that are necessary to induce their acceptance of the substitute investment. Therefore it must determine in advance of the offer of the new bonds what inducement, or combination of inducements, is most likely to strike a responsive chord with the holders of the greatest amount of the bonds.

**Bankers' Participation.**—Whatever the inducements offered, not all bondholders will be likely to be persuaded to accept bonds of the new issue in exchange for their present holdings. Some prefer cash and welcome the call of their bonds by the corporation. Bonds so held must be redeemed when the corporation sends out its call for redemption. Some bondholders do not need the cash, but they cannot make up their minds to accept new bonds in place of the old. Cash must be reserved to pay off the holdings of such bondholders if and when they come to a conclusion. Incidentally, cash may need to be held for some time for such people and for bondowners who cannot be located by the corporation when it issues its call for redemption. When most bond issues are called for redemption before maturity in order to refund them with a new issue, some cash will be needed to pay off those who do not accept the bonds of the new issue. Since the amount of new bonds that must be sold to provide the funds for such redemption



is always uncertain in advance, it is not uncommon to have refunding-bond issues underwritten by bankers. Should the corporation have access to ample funds to meet its redemption needs, it may see fit to avoid underwriting expenses. However, should it fail to gauge the market correctly, the consequences might be quite disastrous if the new issue is not underwritten. The cost of an underwriting commission has frequently proved to be economical insurance for the issuing corporation.

**Meaning of Conversion.**—Another old but still common method of extinguishing an existing bond issue is to have it converted into stock. Conversion means the exchange of one class of security for another under conditions set forth in a previously existing contract. A conversion right is a privilege that the holder of the convertible security possesses by virtue of his ownership of such security. At the time the convertible security is issued, its indenture gives to its holder or his successor the privilege of exchanging his security, at his discretion, for a predetermined amount of another kind of security, as set forth in the indenture or in any subsequent supplement thereto. Conversion rights may be conferred either in the original contract or by a later supplement. When such rights are given subsequent to the original issue, some other privilege is usually taken away in exchange.

In the exercise of a conversion right, a bondholder, for example, usually gives up a more secure contract in return for a security that promises larger income. More often than not bonds are converted into stock, preferred stock into common stock, etc. While there are so many varieties of conversion contracts in use that generalizations are dangerous, nevertheless the change from security to hoped-for income is most often expected. The conversion right which any specific bond issue carries may become very valuable. On the other hand, conditions may be such that they never warrant its exercise. It is important to note at the outset that the original purchaser of a convertible bond always pays something for his conversion right. The bond plus the right always command a higher price than could be obtained for the bond alone. Such rights always cost at least as much as they are worth. Some of the so-called privileges of the bondholder later develop into obligations as will be shown presently.

**Uses.**—The conversion privilege appeals particularly to those security buyers who presently lack the courage to become stockholders but who are not content to continue indefinitely as bondholders. By buying bonds that are convertible into stocks, they can be bondholders temporarily but may later become stockholders at their discretion, through the exercise of the conversion privilege, whenever it appears to them that they would gain in the process of the exchange. The purchase of convertible bonds gives them the opportunity to have their cake and eat it too. As long as they question the existence in the stock of the qualities that they seek, they retain their

status as bondholders. If and when the stock becomes sufficiently attractive to them, they exchange their bonds for stock under the conditions stipulated in the bond indenture. Since such people are more numerous in periods of prosperity, when their optimistic tendencies have a better opportunity to function, it is to be expected that most convertible issues are offered for sale in such periods.

The extent of the use of convertible bonds is indicated by Knight's study<sup>1</sup> of more than \$60,000,000,000 of corporate bonds and notes reported in the financial press for the years 1909-1937. Of this total, 12.44 per cent were convertible. The proportions varied during this period from 4.54 per cent in 1924 to 37.94 per cent in 1929. The percentage distribution of 993 convertible-bond issues, by type of industry and by kind of bond, is shown in the following table:

Type of industry	First mortgage	Junior mortgage	Collateral trust	Debenture	Total
Industrial.....	37 0	2.9	5.3	54.8	100.0
Public utility.....	14.5	7.0	15.5	63.0	100.0
Railroad.....	8.5	18.7	20 3	52 5	100.0
Financial.....	12.2	7.3	15.8	64.7	100.0
Total.....	26.8	5.4	10.0	57 8	100.0

While convertible bonds appeal particularly to so-called "speculative investors," they are bought also by "investors" interested primarily in the income return on what they hope to be safe places in which they put their funds. To the extent that convertible bonds appeal to the investor class as sound investments, the members of this class will buy them without much reference to the conversion rights attached to them. In like manner, even those classed as "speculators" may buy convertible bonds primarily from the point of view of their chances of appreciation in price. At least enough of the investor and speculator classes bid for convertible bonds to broaden their market. And of course it is understood that these so-called classes of security buyers are not fixed in character. A speculator today may become more conservative in his future commitments; and an investor may occasionally wish to take a chance on a more speculative security.

Convertible bonds serve other uses also. Indeed, among the early uses in American experience were the fascinating experiences of Drew and Gould in maintaining control over their railroad empires by the purchase of convertible bonds whenever their control was threatened. Since the bonds could be converted into stock, at the discretion of their holders, outsiders had

<sup>1</sup> Knight, Earl L.: "Convertible Securities," pp. 118 and 149, unpublished Ph.D. dissertation, Ohio State University, 1940.

little chance to purchase enough stock in the open market to take control away from the insiders.<sup>1</sup>

But, in most instances, the conversion privilege is just a "sweetener" to add marketability to bonds that lack independent market appeal. The conversion privilege is, in effect, a substitute for one or more of the qualities that induce investors to buy bonds as such. A corporation with faith in its future views its convertible bonds as interim certificates, issued pending the acceptance by the investing public of the stock into which the bonds may be converted. The corporation whose bonds are actually converted always sells its stock in this manner at prices that are higher than it could have secured by other methods. Frequently, this is a means of marketing stock that could not be sold at all otherwise.

**The Conversion Contract.**—Because of the practically unlimited possibilities of conversion rights, it is especially important that the conversion contract should be very carefully drawn. This is true whether conversion rights are granted at the time the bonds are originally issued, or whether they are conferred in a supplemental agreement. At least the following subjects must be carefully defined: the conversion ratio, or the number of shares of stock that may be obtained for each \$1,000 bond; the period within which the conversion right may be exercised; the specific kind of security or securities into which the bond may be converted; the protective covenants, if any exist; and the limitations upon the use of the conversion privilege. Because so many outstanding securities are convertible and because the use of the conversion privilege always appears in some form in every period when new securities are commonly sold, each of these subjects will be discussed separately. Several of them are quite complex in nature and require considerable study before too much should be paid for the conversion privilege. It goes without saying that there are no universal rights that may be assumed for convertible bonds. Each contract must be studied to learn its contents and their meaning.

**Conversion Security.**—The kinds of securities into which bonds may be converted cover a wide range, from common stock to cemetery lots. Many public utility notes, issued at a time when the market for the sale of long-term bonds was not too favorable, were convertible into bonds. This was just a means of disposing of long-term bonds by indirection. For the most part, bonds and notes are convertible into some kind of stock. Where bonds are convertible into preferred stock, the dividend rate on the latter is usually somewhat higher than the interest rate on the bonds. For example, Central States Electric Corp. debenture 5s are convertible into \$6 preferred stock; G. R. Kinney secured 7½s, into \$8 preferred stock; and American Electric Power Corp. 6s, into \$7 preferred stock. For the most part, however even bonds are convertible into common stocks, since the common has wider

<sup>1</sup>See account by C. F. Adams, Jr., entitled *Chapters of Erie*, reprinted as Chap. I in W. Z. Ripley, "Railway Problems," 1913.

speculative appeal than preferred. Since it is a desire for speculation that prompts bondholders to change their bonds into stocks, it is to be expected that common stocks offer the wider speculative appeal. Of 291 convertible bond issues cited by Dewing, 76 per cent were convertible into common stock, 21 per cent into preferred, and 3 per cent into two or more stocks. Of 102 note issues, 66 per cent were convertible into common stock, 17 per cent into preferred, 11 per cent into two or more stocks, and 6 per cent into bonds.<sup>1</sup>

NUMBER OF ISSUES OF CONVERTIBLE BONDS AND NOTES, 1926-1935\*

Year	Maturing in more than five years	Maturing in five years or less	Total
1926	45	10	55
1927	40	10	50
1928	43	18	61
1929	97	24	121
1930	49	28	77
1931	14	7	21
1932	4	2	6
1933	...	4	4
1934	6	2	8
1935	12	1	13
	310	106	416

\* Keil, F. A., "Convertible Bonds," p. 26, Ohio State University M.B.A. thesis (unpublished), 1936.

Knight<sup>2</sup> found that 93 per cent of convertible bond issues are convertible into stock of some kind; two issues are exchangeable for real estate; and the remainder, or nearly 7 per cent, were convertible into other bonds. Of the number of convertible issues, 53 per cent called for common stock, 35 per cent called for stock with preferences, and the remainder were of mixed types. Among the latter were split conversion rights permitting the conversion of the bonds into two or more types of stocks; optional conversions, which permit the bondholder to choose among two or more kinds of stock; and intercorporate conversions, which call for exchange of bonds for stock in affiliated companies. Some issues carry consecutive convertible options. Convertible note issues are convertible into convertible bonds, which in turn are convertible into some kind of stock. Convertible bond issues are convertible into convertible preferred stock, which is then exchangeable for common stock.

**Lien of Convertibles.**—Of the 310 convertible bond issues studied by Keil for the period 1926 to 1935, 167 were debentures; 36 were designated

<sup>1</sup> Dewing, A. S., "A Study of Corporate Securities" (New York, 1934), pp. 387-388.

<sup>2</sup> *Op. cit.*, pp. 186ff.

DOLLAR VOLUME OF CONVERTIBLE BONDS AND NOTES, 1926-1935\*  
(000,000 omitted)

Maturity	Industry			
	Railroad	Public utility	Industrial	Total
More than five years . . . . .	\$354	\$1,082	\$1,219	\$2,655
Five years or less . . . . .	12	93	156	261
	\$366	\$1,175	\$1,375	\$2,916

\* Keil, *op. cit.*, p. 27.

PER CENT DOLLAR VOLUME OF CONVERTIBLE BONDS TO ALL BONDS—BY INDUSTRIAL GROUPS, 1926-1935\*

Year	Railroads	Public utilities	Industrials	Totals
1926	....	6.4	6.5	5.8
1927	6.1	5.2	2.7	4.2
1928	5.6	12.9	6.0	8.7
1929	19.5	39.9	38.1	33.9
1930	11.2	15.1	20.9	15.8
1931	....	1.6	27.9	6.8
1932	....	7.8	....	6.7
1933	....	6.5	31.2	6.1
1934	24.9	10.2	38.9	21.3
1935	....	...	17.3	5.5

\* Keil, *op. cit.*, pp. 31*f.*

MATURITY OF CONVERTIBLE BONDS AND NOTES, 1926-1935\*

Long-term		Short-term	
Years to maturity	Number of issues	Years to maturity	Number of issues
Under 10 . . . . .	5	1 . . . . .	13
10 . . . . .	134	2 . . . . .	10
11-15 . . . . .	87	3 . . . . .	26
16-20 . . . . .	51	4 . . . . .	3
25 . . . . .	9	5 . . . . .	45
Over 25 . . . . .	17	Variable . . . . .	9
Variable . . . . .	7	Total . . . . .	106
Total . . . . .	310		

\* Keil, *op. cit.*, p. 92.

first mortgage; 10, secured; 16, collateral trust; 43 carried only the name convertible; and the remainder were a miscellaneous assortment of names, most of which indicated some form of security. Of the 106 note issues, 55 were designated convertible only; 15 were secured; 13 were debentures; and the remainder were given various names, most of which suggested some form of security.

**Moody's Ratings of Convertible Bonds.**—Keil made a study of 145 convertible bond issues outstanding from 1934 to 1935 in terms of their rating by Moody. The following table gives the results:

Rating	Per cent of total	Moody's meaning of rating
Aa } A }	12	Investment
Baa.....	14	Speculative
Ba.....	9	Uncertain
B.....	12	Unstable
Caa.....	5	Poor
Ca.....	2	Short of tests
None.....	46	

In other words, only 12 per cent of the 145 convertible bonds studied were given an "investment" rating by Moody; 42 per cent were rated as speculative or lower; and 46 per cent were not rated at all. In a similar study of 911 convertible issues for the years 1909 to 1937, Knight<sup>1</sup> found the following results:

Rating	Per cent of total	Moody's meaning of rating
Aaa } Aa } A }	7	Investment
Baa.....	14	Speculative
Ba.....	12	Uncertain
B.....	6	Unstable
Caa.....	2	Poor
Ca.....	1	Short of tests
None.....	58	

<sup>1</sup> *Op. cit.*, p. 171.

Such studies confirm the statement made earlier in this chapter to the effect that the conversion privilege is a "sweetener" to add marketability to bonds that lack independent market appeal. Keil's and Knight's studies certainly demonstrate the relatively low investment qualities of bonds that carry the conversion privilege.

**Conversion Ratios.**—Ratios of exchange of bonds for other classes of securities into which they are convertible follow a great variety of patterns. In the earliest use of convertible bonds, it was common to provide for an even exchange—10 shares of \$100 par stock to be exchanged for \$1,000 in bonds, for instance. Later this was changed so that bonds became convertible into stock at more than par for the stock: *e.g.*, each \$1,000 bond could be exchanged for stock, par \$100, at \$125 per share. In Knight's study,<sup>1</sup> the distribution of conversion prices for \$100-par stock receivable in exchange for bonds and notes is shown in the following table:

Conversion Price	Percentage Distribution	
	Bonds	Notes
Parity . . . . .	59.5	59.2
Premium (ratio over 100) . . . . .	32.1	28.8
Discount (ratio under 100) . . . . .	8.4	12.0
Total . . . . .	100.0	100.0

Conversion at parity means that a \$100 bond is exchangeable for \$100 in stock. Premium conversion means that a \$100 share of stock is exchangeable for more than \$100 in bonds. Discount conversion signifies that a \$100 share of stock is worth less than a \$100 bond.

The introduction of the use of no-par stock complicated conversion ratios somewhat. The exchange must be in dollars per share or in the number of shares per \$1,000 bond instead of percentages of par. Each \$1,000 convertible note of the American Rolling Mill Co. was made convertible into 40 shares of no-par common stock. Conversion ratios sometimes vary during the conversion period. The International Cement Corp. 4 per cent convertible debentures were convertible into common stock at \$35 per share in 1936, \$40 in 1937 to 1941, and \$45 in 1942 to 1945. Where ratios vary, they always provide a larger number of shares of stock per \$1,000 for the early years than for the later years. From the standpoint of the issuing corporation, early conversion is encouraged. Sometimes the conversion ratios change with the amount of stock converted instead of with the passage

<sup>1</sup> *Op. cit.*, p. 201.

of time. For example, the first 25 per cent could be converted at \$40 per share of stock, the next 25 per cent at \$45, etc.

It should be kept in mind that conversion ratios are so fixed at the time the bonds are issued that they anticipate an increase in the value of the stock into which the bond is convertible. For example, when a \$1,000 bond is convertible into common stock at \$40 per share, it means that, at the discretion of the bondholder, he may turn in his bond to the corporation and receive therefor 25 shares of stock— $\$1,000 \div \$40 = 25$  shares. At the time the bonds are issued, the stock will invariably be selling at somewhat less than \$40. The difference is sometimes quite marked. If the bonds are sold when the stock is selling at a high price, the probability that it will ever be desirable to convert the bonds is not great. For example, the holders of most convertible bonds purchased at the peak of the 1929 stock-market boom have never had much occasion since to think of their conversion privilege as having any value.

**Conversion Periods.**—The conversion period is the time during which the bondholder may exercise his privilege to exchange his bond for stock or other securities. For short-term bonds and notes, the conversion period may be practically coterminous with the life of the bonds. In 1937, the Central Ohio Light and Power Co. sold 3-year  $4\frac{1}{2}$  per cent secured notes, convertible up to 10 days of maturity or earlier redemption into 5 per cent first mortgage bonds due in 1962. With long-term bonds, on the other hand, the conversion period sometimes begins some years after the bonds are issued and ends a considerable time before the bonds mature. In other words, the conversion period encompasses the middle life of the bond. The reasons for this are obvious. As pointed out in the preceding paragraph, the conversion ratio always anticipates a rise in the value of the security into which the bond is convertible. Soon after its issue, therefore, there would be little or no incentive for the bondholder to exercise his conversion privilege. Also, since the bondholder is not certain that he wants to become a stockholder at the time he buys the bonds, he needs a waiting period to determine whether or not the stock of the corporation will ever become seasoned enough to warrant conversion of the bonds.

The majority of convertible bond and note issues grant exchange privileges for the entire term of the obligation. The table on page 271 shows the proportion of convertible bond and note issues that contained abbreviations of the option term which were disposed of during the years 1900 to 1937.<sup>1</sup>

The length of the waiting period, in cases where conversion options are deferred, varies from less than 1 to more than 5 years. In 40 per cent of the cases the waiting period is 1 year or less. In nearly three-fourths of the cases, the waiting period is less than 2 years. In a few instances the

<sup>1</sup> Knight, *op. cit.*, p. 219.



Type of industry	Percentage of convertible bonds with	
	Retarded date of privilege	Privilege lapse before maturity
	Bonds	
Industrial.....	14.6	23.7
Public utility.....	36.7	40.6
Railroad.....	42.4	69.5
Financial.....	15.9	39.0
Total.....	22.6	33.4
	Notes	
Industrial.....	10.3	15.1
Public utility.....	29.5	12.1
Railroad.....		....
Financial.....		20.0
Total.....	17.4	13.8

termination of the waiting period is determined by some contingency, such as the completion of a construction unit or the establishment of a stated earnings ratio. In a few other cases, conversion is permitted only on the call or the maturity of the bonds. The length of the conversion period varies from 1 to over 25 years, with 10 years the most common. The conversion period is generally some multiple of 5 years. In approximately 80 per cent of convertible bond issues, the indentures permit conversion up to the redemption date when bonds are called. In the other 20 per cent of the cases, the number of days the privilege lapses before the bonds are redeemed varies from 3 to 60, with 10 days the most common.

As has been stated earlier in this chapter, the holder of the convertible bond is in the position of the person who has his cake and can eat it too. The corporation gives him the right to remain a bondholder for a considerable period and then to become a stockholder, through the process of converting his bond into stock. From the standpoint of the corporation, there appears to be no good reason, however, why the bondholder should wait until the maturity date of his bonds and then decide whether to accept the cash or a more valuable amount of stock. For that reason, the conversion period sometimes ends some years before the maturity date of the long-term bonds.

**Shortening Conversion Period.**—When bonds having the conversion privilege are callable, the corporation may definitely limit the time of conversion. Bondholders may be notified at any time that their bonds are called, effective, for instance, in 60 days. This limits the conversion period to the 60 days. Bondholders must make up their minds to exchange their

bonds for stock within that time or lose the right to do so. Such an announcement by the corporation will usually result in forcing conversion of many of the bonds outstanding.

The Lone Star Cement Corp., with \$12,000,000 of 4 per cent debentures outstanding, called the entire issue for redemption in 1937. All but \$6,000 was presented for conversion. Nearly all were converted into stock at \$35 per share. The low price of this stock in 1936 was \$35½, and the high was \$61⅞. In 1936, the Allis-Chalmers Manufacturing Co. called for redemption \$5,000,000 of its \$15,000,000 4 per cent convertible debentures, due 1945. Following this call, \$14,907,500, representing almost the entire issue, was presented for conversion into common stock at \$35 a share. In announcing an extra cash dividend on its common stock, the El Paso Natural Gas Co. notified the holders of its convertible debentures and of warrants that, if they wished to participate in this extra dividend, they must surrender their debentures for conversion and exercise their warrants within a specified time, approximately 4 weeks from the date of the notice.

**Conversion Privilege an Obligation.**—The exercise of the conversion privilege requires the positive decision of the bondholder. Passive attitudes prevent the enjoyment of any benefit that may flow from the possession of the privilege. Failure to convert bonds may cause the bondholder to lose definite values that expire with the close of the conversion period. Suppose, for instance, that a corporation's bonds are convertible into stock at par. As long as the stock sells below par, the price of the bond would reflect little of its right of conversion into stock. The right has merely speculative value. As the stock rises above par, the price of the bond, during or just preceding the conversion period, will follow closely—within a point or two ordinarily. Suppose that the stock reaches approximately \$200 per share—par \$100—and is fairly stable at that level. The price of the bond will be approximately as high, as long as it possesses the conversion privilege. Should the conversion privilege expire on Dec. 31, 1946, the bond would be worth approximately double its face value on that date, according to the example cited: *i.e.*, the value of the bond and the conversion right. The next day the price would reflect only the value of the bond, since the conversion right has expired. The bondholder who fails to exercise his conversion privilege sacrifices approximately half of his investment in this case. He should convert his bond, sell his stock, buy back the bond or its equivalent the next day, and take a trip to Europe with the balance. He can enjoy the same benefit by selling his convertible bond before the conversion period expires and buying it or its equivalent back, without the conversion privilege, the day after the conversion privilege expires.

**Dilution and Protection of Conversion Rights.**—Unless otherwise circumscribed in the bond indenture, a share of stock is a share of stock, in spite of its resemblance to a rabbit. The share that the corporation had when

the bonds were issued may become many shares by the time the conversion privilege is exercised. The conversion right may be diluted by a stock split-up, a stock dividend, issuance of subscription rights, sale of additional stock, sale of other securities having priority in redemption or dissolution, sale of other issues convertible into stock at lower ratios, distribution of assets to holders of securities with prior claims, etc. A sale of assets of the corporation, dissolution, merger, or consolidation may result in the complete elimination of the conversion rights.

Protection against such dilution can be given the bondholder if the bond indenture establishing his rights is so worded that his conversion rights always mean the same thing. For instance, if his right to a share of stock is not exercised until after the stock has been split two for one, he should receive two shares instead of one; if, instead of a stock split-up, a stock dividend of 10 per cent has been declared, he should receive one and one-tenth shares instead of one. The convertible 3½s of the Youngstown Sheet and Tube Co. contain an elaborate method of protecting bondholders against dilution of their conversion rights.

The first antidilution clause appeared in a bond issue in 1906 when the American Telephone and Telegraph Co. issued \$150,000,000 of 4 per cent gold debentures.<sup>1</sup> Protective features of this character did not become common until the late 1920's. After that time, antidilution clauses became an expected feature of convertible bond issues, as the following table covering the period 1928 to 1937 shows:

Type of industry	Percentage of convertible bonds with antidilution clauses	
	Number of issues	Dollar volume
Industrial . . . . .	42 2	67 8
Public utility . . . . .	27.9	53.7
Railroad . . . . .	65.0	83 0
Financial . . . . .	44 6	75.8
Total . . . . .	39.8	65.8

**Special Conversion Features.**—Some convertible bond indentures contain features not commonly found in such papers. The term "double conversion" describes the situation arising from the right of holders of two or more bond issues to convert into the same kind of security. Optional conversion permits the holder of a bond to convert it into either or all of two or more securities. The Armstrong Electric and Manufacturing Corp. first convertible 7s had this privilege. Discretionary conversion gives either the

<sup>1</sup> Knight, *op. cit.*, p. 214ff.

corporation or the bondholder the right to change the character of the security. The London Terrace Apartments convertible 6s have such a provision.

In intercorporate conversion, the bond of one corporation is convertible into securities of an affiliate: *e.g.*, East Coast Utility Co. secured 6s and Albuquerque National Gas Co., 6½s. Mixed conversion gives the holder a right to acquire a combination of other securities according to a fixed ratio. American Service Co. convertible 7s were convertible into 6 per cent bonds and four shares of common stock.

**Conversion at Option of Corporation.**—The 5½ per cent convertible investment certificates of the Associated Gas and Electric Co., due 1938, were convertible at any time at the option of the holder of each \$1,000 certificate into (1) a like principal amount of 5 per cent convertible gold debentures, due 1965, which in turn were convertible at the holder's option, between 1933 and 1943, into 10 shares of \$5.50 preferred stock; or (2) 15 shares of Eastern Utilities Investing Corp., consisting of 3 shares of \$5 cumulative prior preferred stock, 2 shares of \$6 cumulative preferred stock, 5 shares of participating preference stock, and 5 shares of Class A common stock. After 1933, at the option of either the company or the holder, each \$1,000 investment certificate was convertible into 10 shares of the company's \$5.50 preferred stock. The company could not exercise its option if dividends on this stock were in default. In 1936 and 1937 the Garlock Packing Co. issued 10-year 4½ per cent debentures to stockholders in lieu of cash dividends. They were convertible solely at the option of the company into a 5 per cent preferred stock issue to be created at some future time.

**Convertible Bonds and Short Sales of Stock.**—A speculator who is on the short side of the market may hedge by the purchase of convertible bonds. If he has used bad judgment and sold short stock that is about to go up in price, he can convert his bonds and cover his short sales, limiting his loss to the costs of the operation. If the price of the stock goes down, he can cover by purchase of stock in the open market. Since the bond is still a bond, it will probably not go down in price as much as the stock. The profit on the stock will more than offset the loss, if any, on the bonds. This possibility broadens the market for convertible bonds.

**Investment Status.**—Convertible bonds should be looked upon as securities with a dual personality. In attempting to measure the investment qualities of any bond in this class, this dual relationship must be evaluated. Furthermore, it must be weighed by separate sets of scales. In the first place, the bond must be weighed as a bond, irrespective of its right to be exchanged for stock. This is the primary value to be placed upon the bond. To whatever value is attached to the bond as a bond may be added the value, if any, of the speculative right to convert the bond into

stock. The capacity of the corporation to meet the primary obligation on the bond—its promise to pay—may vary with the changing fortunes of the business. The bond might be so well secured by assets and earning power that it would seldom drop below its face value. Or, due to either external or internal causes, or both, it might drop in value quite materially. It would not disappear or drop too low except when the corporation was in dire financial straits.

The value of the conversion right, on the other hand, starts from near zero at the time the bonds are issued. Since there would never be any incentive to convert until the fortunes of the issuing corporation improve, the starting value is highly speculative. It may never advance beyond this stage. On the other hand, it may acquire real value which is reflected in the quoted prices of the bonds. On rare occasions, the value of the conversion privilege may mount so high as to completely overshadow the bond as a bond. But a reversal of the conditions that carried it to such heights may again result in the complete disappearance of the value of the conversion privilege. The value of the bond and of the conversion privilege should be kept separate. The purchaser should not confuse the two or think they stem from the same root. Nor should the purchaser of a convertible bond be misled into centering his attention upon either attribute of the bond to the exclusion of the other.

### QUESTIONS AND SUGGESTIONS

1. What is meant by refunding? How are extended bonds related to refunding operations? How do they differ?
2. It is ever advantageous for a bondholder to refuse to extend the maturity of his bonds? Explain.
3. Will a corporation gain or lose by refunding its bonds at their maturity date? Explain.
4. Why do corporations refund bonds before their maturity? Have railroads refunded many bonds before maturity in recent years? Why?
5. What proportion of bonds issued recently were for refunding purposes? Why?
6. What is the attitude of bondholders whose bonds are called for refunding purposes? What inducements are sometimes offered to secure the acceptance of new lower interest bonds?
7. How does the corporation obtain the cash needed to pay off those bondholders who demand it?
8. What is meant by bond conversion? Into what kinds of securities are bonds usually convertible? Are conversion rights always valuable? Explain.
9. Why do corporations grant conversion rights to bondholders? To what classes of security purchasers do convertible bonds appeal? Why?
10. With what classes of bonds is the conversion right usually associated?
11. What is the conversion ratio? Does it ever change? Explain.
12. During what part of the life of the bond is the conversion right available? What is the waiting period? Why should there be one?
13. Why does the conversion right sometimes lapse before the bond matures?

14. What happens to the conversion right when bonds are called? How are conversion periods sometimes shortened?
15. In what way may the conversion right become an obligation?
16. What are antidilution clauses in bond indentures, and why are they used?
17. How can bonds be protected against dilution of conversion rights?
18. Account for the use of conversion of bonds at the option of the corporation.
19. How are conversion rights related to short sales of stock?
20. How can you determine the investment status of convertible bonds?

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#### SUBJECTS FOR INVESTIGATION

1. From any manual select five examples of bonds that have been issued to refund other bonds. What advantages did the corporations involved gain from such refunding operations?
2. Find five examples of convertible bonds, and tell in each case into what kinds of securities the bonds can be converted.
3. Find five examples of convertible bonds whose ratios change during the life of the conversion privilege, and account for the changes.

## CHAPTER XVI

### STOCK PURCHASE WARRANTS AND OPTIONS

**Background.**—Stock purchase warrants constituted one of the outstanding characteristics of the hectic decade of the 1920's. They had been used in a few isolated cases as far back as 1911. The real demand came as a result of the boiling stock market of the 1920's. Before the collapse of the stock market in 1929, the number of speculators had increased tremendously. Not only were there many new names on corporate stock ledgers, but "speculative investors" became "speculators," and "investors" became more speculatively minded. Few were content to earn a fair return on a safe investment. Nearly everybody wanted to participate in the fabulous paper profits being made by owners of stock. In such a market, the producers of securities racked their brains to discover new methods of creating sales appeal for their securities. One discovery brought forth the wide use of stock purchase warrants.

**Meaning.**—A stock purchase warrant is closely akin to the conversion privilege attached to a bond issue. As first used, the two were very similar in their effects. As first planned, the warrant, attached to the bond, gave its holder the right to buy a specified number of shares of stock of the issuing corporation within a time fixed in the warrant and at a price designated therein. So long as the purchaser of the bond retained it, his right to participate in the success of the corporation by purchase of its stock was assured, up to the time of expiration of the rights. Should he sell his bond, his attached warrants were also transferred to the purchaser. Hence instead of ceasing to be a bondholder, when it became advantageous to exercise the rights granted by the stock purchase warrants, the bondholder thought he could retain his bond and become a stockholder as well.

From the standpoint of the corporation, in case the stock was purchased by the bondholder, the money used in payment therefor could be used to pay off the bonds, assuming that they possessed the call privilege. As a consequence, the bondholder would get back the money he paid for the stock—perhaps not the exact amount—he would become a stockholder instead of a bondholder, and the corporation would effectively have exchanged its stock for its bonds. Hence the relationship to bond conversion is evident. If the story ended at this point, we might just as well have added a few paragraphs to the preceding chapter and considered that

stock purchase warrants are simply another method of converting bonds into stock. Since this is the beginning and not the end of the story of stock purchase warrants, separate treatment seems justified.

**Contents of Warrants.**—Since the stock purchase warrant constitutes a contract between its owner and the issuing corporation, its content is of both legal and financial importance. Like many documents used in business finance, there is no standard pattern that must be followed. Their possible contents cover a wide range, both as to subjects dealt with and the manner of dealing with them. Some are so briefly stated that they leave grave doubts about the chain of legal relationships that they establish. Perhaps their authors did not take them too seriously or expect that financial conditions would ever warrant their use. Others are so minutely detailed that one might think each warrant was expected to be used at an early date. The subjects that should be covered include the following: the class of stock and the exact number of shares that may be purchased with each warrant; the price or prices to be paid; the method of payment, whether cash or the surrender of the securities sold with the warrant in lieu of cash; the period during which the warrant can be used; the protection—if any—which the warrant holder has against its dilution; and whether or not the warrant is detachable.

**Detachable Warrants.**—The early use of stock purchase warrants as a “sweetener” to induce the purchase of a bond issue, which the corporation might have difficulty in selling otherwise, assumed that the warrants would be attached to the bond and would change ownership only when the bond was sold. Presently this was changed to read that after the bond had been held for a specified period—say 1 year after its original issue—then the warrants could be sold and the bond retained. Even in such case the corporation could still use the cash submitted to it by the new owner to pay for stock purchased with the warrant. If it used this cash to redeem the bonds to which the warrants were originally attached, the only change effected by making the warrants detachable would be to change the ownership of the stock.

But the change to detachability of the warrants was much more far reaching. If they could be made detachable at the end of 1 year, why not make them detachable at once? That would make the warrants eligible to be bought and sold without reference to the change in the ownership of the bonds with which they were sold. Trading in warrants becomes a separate and distinct speculative pastime. As such, it is similar to margin trading in stock. The holder may profit from increases in stock prices, without making much of an original capital investment. He may limit his losses to the amount paid for the warrants. In fact, long-term warrants may provide fuel for speculation and may change hands many times without ever being presented for use.



**Time Limitations on Use.**—Like conversion rights, stock purchase warrants must be exercised within the time limits set in the contract. After that they cannot be used, and hence they cease to have value. Should the bonds to which they are attached be called within the time the warrants are usable, the warrants may be returned to the bondholder when the bond is called for redemption. For example, the 15-year 3¾ per cent debentures of the National Dairy Products Corp. carried nondetachable stock purchase warrants good for 3 years. It was provided in the contract that the warrants were returnable if the bonds were redeemed within the 3-year period.

Starting with short terms for the exercise of warrants, 1 to 3 years, the terms were soon lengthened until many of them had no expiration date. In 1929, the State of Delaware specifically authorized corporations domiciled in that state to issue perpetual warrants. Previous to that date, perpetual warrants had been used without specific legal authority.

**Purchase Price.**—The prices at which the holders of warrants have the right to buy stock from the corporation usually anticipate improvement in earnings and in credit standing. Like convertible bonds, warrants would seldom be used at the time they were issued. For example, if the stock is selling at \$35 per share at the time the warrants are issued, the warrants might give their holders the right to buy stock from the corporation at \$50 per share. As long as the stock sells at less than \$50 in the open market, the warrant is practically valueless and would not be used. As soon as the stock approaches \$50 per share, the warrant acquires speculative value. Within the time limit set in the contract, the holder of the warrant has the right to purchase stock from the corporation at \$50 per share, up to the number of shares his warrant calls for, regardless of the market price of the stock.

The price fixed in the contract may remain constant throughout the life of the warrant. For example, the sinking-fund debenture gold 6s of the American Solvents and Chemical Corp. carried warrants allowing the holder of each bond to buy, at \$40 per share, 25 shares of its common stock at any time during the life of the warrant. On the other hand, it is a common practice to provide for progressive increases in the price of the stock to be purchased with the warrants. Some of the increases in price are quite complicated. For example, stock purchase warrants attached to the first mortgage gold 6s of the Mead Corp. gave the holders thereof the right to purchase up to 1937, with each \$1,000 bond held, 10.34802 of common stock at \$38.65473 per share. If the rights were exercised after 1937 but before 1940, the holder of a \$1,000 bond was entitled to buy 10.391417 shares of common stock at \$48.11662 per share. The use of a rising scale of prices, by years, induced the early exercise of the rights granted by the warrants.

**Fluctuations in Value.**—Warrants for the purchase of stock at values yet to be demonstrated are not expected to have more than long-shot speculative

values at the time they are issued. Like the conversion privilege of bonds issued at the peak of booming stock markets, warrants that anticipate stock values higher than the highest prices ever reached never attain real value. On the other hand, warrants that permit the purchase of stock that does go up sharply in price may pay their owners handsome profits. During the decade of the 1920's, warrants were more commonly used by public utility holding companies than by corporations in any other major industry. One of the fantastic demonstrations of the speculative possibilities of warrants occurred in this industry. In 1927, the American and Foreign Power Co. issued warrants giving their holders the right to buy stock at \$25 per share. Before the stock-market crash 2 years later, the stock had risen in price to \$200 per share. The warrants sold at a correspondingly high price of approximately \$175 each. Warrants frequently demonstrate the truth of the old adage that what goes up can come down. In 1925, the Commercial Investment Trust Corp. issued warrants to buy its common stock at \$80 per share. Four years later, in 1929, the warrants were quoted at \$69.50 each. In another 4 years, 1933, the common stock dropped to \$30 per share, or \$50 below the minimum price at which the warrants would be exercised. The value of the warrants completely disappeared.

**Advantages of Warrants.**—To the issuing corporation, the use of stock purchase warrants often adds the element of sales appeal, without which the security to which they are attached would not sell readily. The psychology of warrants is sound. A purchaser of a bond or a share of preferred stock is induced to believe that *when* a share of common stock, which is now selling at \$20 a share, reaches \$40 per share in the open market, he can make a profit of \$10 a share by taking advantage of his privilege to buy the stock from the corporation at \$30 per share. With this prospect in view he is not likely to ask, "What are the chances that the stock will ever reach \$40 or even \$30 per share?" Furthermore, if the holders of bonds or preferred stock with their stock purchase warrants attached actually exercise their rights to buy the stock called for in the warrants, they provide the corporation with funds that may be used to retire the bonds or the preferred stock. Indeed, in some cases, the contract requires the corporation to use such funds for these purposes. For example, Remington Rand, Inc. is required to use the proceeds from the purchase of stock with its outstanding warrants to retire its funded debt and its preferred stock, to the end that ultimately it will have outstanding only common stock.

The advantages of stock purchase warrants to their owners are similar to the ownership of convertible bonds and preferred stock. To the cautious investor who would like to be bold—if he dared—the purchase of the bond or the preferred stock seems to protect his caution, while the chance to buy stock through the exercise of the warrant gives him the chance to be bold.

Even where warrants are issued under such circumstances that the likelihood of their exercise is not great, their holders still enjoy the feeling that, sooner or later, there *may* develop an opportunity to profit from their ownership. As long as stock purchase warrants help to satisfy the desires of speculators, they may be said to offer some advantages to their owners. To be sure, the advantage is frequently psychological and may not command much of a price in the market.

**Uses of Stock Purchase Warrants.**—Starting from the use of stock purchase warrants as substitutes for the use of convertible bonds, their possibilities soon became evident to bankers and security salesmen. During the decade of the 1920's, when they enjoyed their greatest popularity, they were used both in the distribution of other securities and in other ways. As sweeteners to induce the acceptance of other securities, they were used with bonds and preferred stock issues that did not possess sufficiently strong market appeal to stand on their own merits, with common stock for similar reasons, in corporate reorganizations and consolidations to induce the acceptance of securities otherwise unacceptable, and in refunding operations to induce the acceptance of bonds or other securities handicapped by features that produced sales resistance or offered at unfavorable periods.

It was really in the distribution of warrants without accompanying securities that corporations found the most unusual uses for them. In some treatises, the word "option" instead of "warrant" is used to define some of these uses. While granting that there may be slight differences in the connotations of these two terms, they are nevertheless used synonymously in this discussion. The effects are the same, at least. Among the ways warrants for the purchase of stock were used where no other security issue was involved are the following: as part or sole compensation of promoters; as part compensation to underwriters; as part compensation for banking services; as part compensation to existing managements of corporations; as inducements to obtain the services of new executives; in exchange for amounts due under contractual rights, such as overdue interest on bonds or accumulated dividends on preferred stock; in exchange for investment not otherwise required; and in sale for cash without any other consideration being involved.

**Warrants as Sweeteners.**—Stock purchase warrants have been used as sweeteners to induce the purchase of various classes of securities, from bonds to common stock. Avery and Sons Co. used them with both bonds and preferred stock. Each 5 per cent sinking fund bond of \$1,000 denomination carried the right to buy 40 shares of common stock at \$10 per share. Each share of 6 per cent cumulative preferred stock, par \$25, carried the right to buy 2 shares of common stock at \$10 per share. The relative advantage to the holders of the preferred stock, in comparison with that given the bondholders, presumably reflected the greater risk assumed by the former.

In 1920, S. S. Kresge Co. recognized the value of warrants as sweeteners in pricing the debenture bonds which it sold in that year. Some were sold with detachable warrants and others without. The latter returned a higher income yield than the former. Even common stockholders are sometimes favored with the right to purchase additional shares. The Bradford Oil Refining Co. offered to its common stockholders the right to buy two shares for each three shares held. The price of the new stock offered was \$1 per share. Every stockholder who took advantage of this offer was given warrants to buy additional shares, any time within a specified period of several years, at the same price of \$1 per share. In all cases where the stock purchase warrants are used as sweeteners, the evidence is pretty strong against the acceptance of the security offered without some added inducement.

**Statistical Summary.**—For the 6-year period from 1925 to 1930, Moody's and Poor's *Manuals* record 8,908 American security issues having total par (or selling value in the case of no-par issues) value of \$28,496,061,156. Of this total, 5.9 per cent in number and 7.4 in value carried stock purchase warrants. Investment trust issues carrying purchase warrants represented 8.9 per cent in number and 16.2 in value of all such issues. At the other end of the line were railroads with only 1.3 per cent in number and 4.9 in value.

The use of warrants was progressive throughout most of the 6-year period. By 1929, 10.1 per cent in number and 18.9 in value of all securities issued carried stock purchase warrants. Warrants did not appear in the railroad field until 1929.

Of the 527 issues carrying stock purchase warrants during the period studied, 257 were bonds, 183 were preferred stocks, 47 were note issues, 14 were Class A common stocks, 10 were common stocks, and 16 were blocks of more than one type of security. Of the 527 issues, 519 permitted the purchase of common stocks, and 8 permitted preferred stock purchase. In 315 cases, step-up prices were provided, while in 212 cases constant prices prevailed. In 28 cases, warrants were perpetual, while in 499 cases their life was limited. In only 151 cases, or 28.7 per cent of the total, was there protection against dilution of the warrants. In 30.5 per cent of the cases, the warrants were detached or immediately detachable; in 11.8, detachable after the lapse of time; in 31.3, nondetachable; and in 26.4, nothing was said about separability.<sup>1</sup>

**Moody's Ratings.**—Of 142 warrant-bearing bonds and notes issued by railroad, public utility, and industrial corporations during the years 1925 to 1930, and rated by Moody, only 5.6 per cent had ratings of A or better; 23.2 were rated Baa; 59.2, Ba; and 12, B. Of 83 warrant-bearing preferred

<sup>1</sup> Woodbury, C. H., "Stock Purchase Warrants," pp. 55ff., Ohio State University M.B.A. thesis (unpublished), 1935.

stocks studied, none were rated A or better; 15.6 per cent, Baa; 55.4, Ba; 27.7, B; and one issue was rated Caa. This study shows the unmistakable speculative character of securities that reach the market only when sweetened with stock purchase warrants. Most of the bonds and preferred stocks studied did not even have a rating by Moody.<sup>1</sup>

**In Reorganizations.**—When it becomes necessary to reorganize corporations because of financial embarrassment, the holders of residual claims may have little or no equity to support their continued participation in the business. Common stockholders, preferred stockholders, and even, on occasion, holders of some classes of bonds may not have any real claim on the assets or the earning power of the failed corporation. Since their claims are worthless, they can be “wiped out.” Sometimes they are completely eliminated when it is evident that there is nothing left to protect their claims. Financial ethics, however, dictate that all who participated in the affairs of the corporation up to the time of its failure should be given some opportunity to share in its recovery. Various plans have been used to invite continued participation by these classes of security holders. These are described in detail in the later chapters on corporate reorganization.

During the decade of the 1920's, with the extensive use of stock purchase warrants for other purposes, it is not surprising that they were found useful in reorganizations. In the place of old stock that was eliminated in the process of reorganization, the holders were given warrants to buy new stock if and when the improved fortunes of the reorganized corporation made such purchase desirable. Such warrants represent merely a “certificate of hope” that future operations will justify their use. They cost the corporation nothing. Their use satisfies any legitimate claims which present holders of worthless securities might have against future improvement in the corporation's affairs. Those who receive such warrants are inclined to accept them without question in lieu of other means that they might use to press their claims. For example, in the reorganization of the International Paper and Power Co., the common stockholders were given the right to purchase the new common at \$25 per share. The warrants had a life of 4½ years. Since no new money was expected from this source immediately, the directors were authorized to issue at any time and at any price any part of the authorized stock.

**In Refunding.**—The position of bondholders in refunding operations was defined in the preceding chapter. It was noted at that time that many refunding plans depend for their success upon the willingness of the holders of the large majority of outstanding bonds to accept bonds of the new issue in exchange for their present holdings. Various means are used by corporate managements to induce this exchange. Among them are the addition of stock purchase warrants. There are occasions when warrants have helped

<sup>1</sup> *Ibid.*, p. 36.

to effect exchanges of new bonds for old. For example, in 1933, admittedly a most embarrassing time to have a bond issue mature, the Baldwin Locomotive Works was unable to redeem a maturing issue. Refunding was necessary. To each holder of a \$1,000 bond of the matured issue, Baldwin offered a new 5-year note and a warrant to buy 40 shares of common stock at \$5 per share. In this particular instance, the warrants helped to prevent a default in the bond contract and possibly more serious financial embarrassment.

**Warrants to Promoters.**—It is a well-known fact that there is no sure plan for compensating a promoter for his efforts. If the new corporation succeeds, he is entitled to liberal payment for his services. If it fails, his enthusiasm has not been justified and he is entitled to less financial consideration. It seems appropriate therefore that at least a part of his compensation should be paid in the form of stock purchase warrants. This does not suggest, however, that all such payments, regardless of their size, are justified. Organizers of the Alleghany Corp. were given warrants to buy 1,725,000 common shares at \$30 each any time up to 1944. Sometimes the exact price to be paid is not specified in the contract. The organizers of Bancorio Corp. received an option to buy 100,000 shares of its stock at any time between 1930 and 1939, at the current fair market price of the stock at the time the option was exercised. In some instances, the compensation paid promoters fails to receive the approval of courts which are asked to review the case. In one New York case, the promoter was given the option to buy the voting stock of the corporation from the profits he made from promoting it. This meant that with no investment of his own funds, other than his profits, he was to be given sole control of the corporation. In declaring this contract void, the court described it as "an extreme case of abuse in corporate organization."<sup>1</sup>

**Warrants to Underwriters.**—Frequently underwriters are given bonuses in the form of options to buy stock not underwritten. The house that underwrote 75,000 shares of Esquire-Coronet, Inc., at \$16, less a discount of \$2.25, was given an option to buy at any time within 2 years an additional 75,000 shares or any part thereof at \$18 per share. Since apparently the underwriter would not be likely to exercise this option if the market failed to absorb the first 75,000 shares, it does not appear that the option was in any sense a protection to the underwriter. On the other hand, if the corporation succeeded to the point that it did not need the proceeds from the sale of the second 75,000 shares, it appears a bit difficult to explain the option from the standpoint of the corporation. Financial practices of this sort certainly do not carry on their face their own justification.

In 1926, the Barnsdall Corp. gave to the underwriters of its bonds an option to buy 500,000 shares of its common stock. At the peak of the

<sup>1</sup> *Heckler v. Emery*, 131 Misc. 393, 226 N. Y. Supp., 599 (1928).

subsequent high market, these shares would have been worth \$13,000,000. Warrants as a part of underwriters' compensation afford a convenient means of concealing from the public the amount of such compensation. Graham and Dodd cite a case in which 55,000 shares of common stock were sold at \$6.75 per share, \$5 of which went into the company's treasury and \$1.75 to the underwriters for selling expenses and profit. The financing charge—up to this point—was 26 per cent. In addition, however, the underwriters were given an option to buy 14,000 shares at \$1 per share. This option was exercised and the stock was sold with the other shares. In reality, therefore, the company sold 69,000 shares at \$6.75 per share, receiving \$4.20 per share only, with financing charges 38 per cent.<sup>1</sup>

The Brown-McLaren Manufacturing Co. and six of its officers and directors, owning 205,000 of its outstanding 250,000 shares of common stock in 1937, entered into an agreement that provided, among other things, the following: The underwriter was given an option to buy 90,000 shares of stock, at step-up prices. During a period of 5 years, the underwriter was given the first right to purchase securities offered by any of them. As long as any of the stock remains subject to the underwriter's rights, the six officers and directors will not voluntarily dispose of any of their shares without the underwriter's written consent.

**Options to Bankers.**—In the familiarity with warrants that bankers have acquired in dealing with corporate shareholders, it is not surprising that they should have found means of feathering their own nests. One common means of sharing in a corporation's prosperity—if it has any—is to acquire an option to buy its stock at such times. Not only are such options given as a partial consideration for assistance in selling securities, but for other financial assistance as well. For example, the Phoenix Securities Corp. placed Loft, Inc., under obligation to it by endorsing the latter's notes. The obligation was met by granting to Phoenix options to buy Loft's stock at varying prices over different periods of time. When it was necessary to extend the notes, the Phoenix obligingly endorsed the extensions and in return secured extended option periods and reduced prices. In some cases, bankers were not even required to buy the stock on which they had an option. In part consideration for financing services, the American Commercial Alcohol Corp. agreed to issue to its bankers one common share for each two shares issued in the exercise of stock purchase warrants. Nontransferable warrants entitling bankers who participate in security distributions to subscribe for stock at a future date are sometimes called "bankers' options."

**Management Options.**—For some years it has been customary for corporations to offer stock to key executives at favorable prices, as a part of their compensation. Some of this stock so offered is unissued stock, while

<sup>1</sup> Graham, B., and D. L. Dodd, "Security Analysis" (New York, 1934), p. 559.

in other cases it was purchased in the open market for the purpose of resale to executives. It is a common saying that General Motors Corp., for example, has made millionaires out of many of its executives by selling them stock purchased at a low price. Taking advantage of the depressed condition of the market for its stock in 1932, the National Cash Register Co. bought in the open market 60,000 shares of its stock at an average price of \$8.16 per share. This was then sold to the company's new general manager at cost plus interest at 4 per cent, less dividends paid while the stock was being paid for. All this stock which was so optioned was purchased by 1937.

Some management options were exercised in quite unorthodox fashion. For example, in 1936, Marshall Field and Co., Inc., gave to its general manager an option to buy 100,000 shares of its stock at \$10 per share. During the early part of 1937, he purchased under this option 20,000 shares of stock. Later in the year he proposed to his board of directors a modification in the contract as follows. He admitted that, should he purchase the stock at the agreed price, he would sell it in the open market to realize the profit. Therefore he proposed that the company give to him the equivalent of the profit that he would realize on 20,000 shares. Under this arrangement, he collected \$313,929 during the third quarter of 1937.

**Warrants to New Executive.**—It is not uncommon to give the new executive head of a corporation an option to buy a block of stock under terms and conditions that represent an incentive to efficient management of the corporation's affairs. When the Blaw Knox Co. elected a new president, the directors made a firm contract with him, subject to the approval of the stockholders, for the purchase by him of 20,000 shares of no-par common stock on the following conditions: The price of the first 1,000 shares was \$25 per share, cash, deliverable as soon as he succeeded in getting the shares of the corporation listed. Before 1942, the president was obligated to pay for the other 19,000 shares in blocks of not less than 500 shares at \$25 per share, less an amount equal to dividend distributions paid by the company from the effective date of the contract to the date payment is made for each block of stock. In other words, the larger the earnings and hence the dividends, the less the new president must pay for his stock. The more successful the corporation and hence the higher the price of its stock, the sooner the president would wish to acquire the stock he had contracted for.

In order to encourage three officers to keep 10-year contracts, the Interstate Hosiery Mills, Inc., gave each of them an option to purchase during each year of the contract, in lots of at least 100 shares, not over 500 shares of common stock at its book value at the end of the preceding year. The General Asphalt Co. granted its president an option to buy 10,000 shares of capital stock at \$30 per share, at the rate of 2,000 shares in each calendar



year from 1937 to 1941 as part compensation on account of its subsidiary, the Barber Asphalt Co.

Such plans are not always approved by stockholders. When the Childs Co. proposed to sell 23,331 shares of its common stock at \$1 per share to five executives, criticism from the stockholders was so sharp that the plan was withdrawn.

**Restricted Options to Officers.**—Options to officers, giving them the right to buy stock within fixed periods at specified prices, are sometimes limited in such manner that no one else may take advantage of them. Loew's, Inc., provided that options for the purchase of 50,000, 50,000, and 100,000 shares of common stock, granted to three officers, be nonassignable. The optionees agreed not to sell, within a specified period, any stock purchased under their options at less than \$15 per share in excess of the price paid. In the event of the legal termination of any optionee's employment prior to a specified date, the options were to be canceled except for certain rights to be continued for a limited period. The Walworth Co. gave its executive head an option, to be effective only during his continuance as head of the corporation, to buy 50,000 shares of its stock at any time during the 4 years following the date of the option. The price at which any block could be purchased was to be the average price of the stock for the 5 years prior to the purchase.

In 1937, the Tubize Chatillon Corp. granted to a group of its executives nonassignable options to buy 10,000 shares of Class A stock and 10,000 shares of common stock. The prices were to be \$30 and \$10, respectively, in 1937 and as fixed by the board of directors for later years. In offering 20,000 shares of stock to selected employees, the Household Finance Corp. stipulated that: the purchasers may not assign such shares without the written consent of the company, the certificates to be so stamped to prevent their sale; the death of the purchaser terminates his option agreement; and the corporation reserves the right to repurchase the shares at a price stated in the contract.

A peculiar option was used by the American Fidelity and Casualty Co., Inc., in authorizing 20,000 shares of \$5 par stock to be held for sale at the order of one of its officers on the following terms: During 1937-1938, \$11.50 per share; 1939, \$12; 1940, \$13; and 1941, \$14. The stock purchased under this option could not be resold within 18 months after its purchase unless the entire holdings be sold at the same time. However, the owner was permitted to pledge his shares. The pledgee may sell the same at any time for the bona fide purpose of collecting indebtedness due him. In consideration of this option, three officers agreed to continue to serve the corporation through 1951 at aggregate annual salaries not to exceed \$30,000.

**Bonus to Executives.**—Some plans for encouraging executives contemplate outright gift of stock instead of options to buy shares. In merging McCormick's, Ltd., in 1937, Weston (George), Ltd., a Canadian corporation,

made an agreement with the president of McCormick's, Ltd., by which he was to assume active direction of the company and to receive, in part payment for his services, the following: (1) Preferred shares equivalent in par value to  $\frac{1}{4}$  the interest paid on first mortgage bonds to May 1, 1940. These bonds have a  $5\frac{1}{2}$  per cent rate, to be paid only out of earnings up to Apr. 30, 1940. (2) After the net current assets reached \$350,000, preferred shares, equivalent to one-fifth of such increase, exclusive of increases from sale of pledged assets or other securities held by the company. (3) 1,500 preferred shares or 15,000 common shares if, at Dec. 1, 1940, net current assets exceeded \$850,000 and the company was not in default on its bonds. (4) 1,500 preferred shares or 15,000 common shares if, at Dec. 31, 1941, net current assets exceeded \$750,000 and the company was not in default on its bond interest. (5) A similar allotment if the stipulated 1941 conditions prevailed on Dec. 31, 1942.

In the reorganization of the Duplex Envelope Co. in 1937, it was agreed that after the retirement of all notes and first preferred stock, 10,000 shares were to be issued to the vice-president, as compensation for his services in rehabilitating the company. Two years after the date of reorganization, but prior to the termination of the voting trust agreement, 5,000 additional shares might be issued to the president or other officials as additional compensation for their services.

**Cash Sales.**—So far in this chapter we have considered the use of stock purchase warrants in connection with the sale of other securities and as inducements to individuals intimately associated with the success of the issuing corporation. The general acceptance of these financial arrangements and their adaptability to many uses recommended their extension into fields that were quite foreign to the original conception of the place of stock purchase warrants in corporation finance. One of the far-fetched uses was their sale for cash. For example, in 1929 the Fourth National Investors' Corp. sold 750,000 stock purchase warrants for \$3,000,000 cash.<sup>1</sup> Regardless of what might be said about the judgment of purchasers of such warrants, it appears that the sale of stock purchase warrants by a corporation management presents some interesting questions about the character of their major objectives.

In contrast to the purchase of warrants with cash, some can be exercised without the use of cash. Some are in the nature of bonuses, while others are employed to induce the exchange of one kind of security for another. The 5 per cent debentures of the Investment Bond and Share Corp. carried nondetachable warrants that entitled their holders to a contingent bonus of common stock. They provided that, on the record date of the first common-stock dividend, or earlier if the board of directors so ruled, the holder of each \$1,000 debenture was entitled to receive a bonus of 10 shares of

<sup>1</sup>Graham and Dodd, *op. cit.*, p. 546.

common stock. The American and Foreign Power Co., Inc., agreed to accept one share of no-par second preferred stock, Series A, and four perpetual stock purchase warrants in exchange for four shares of its common stock.

**Other Uses of Warrants.**—Stock purchase warrants or options have been used for several other purposes unrelated to the original issuance of securities. For example, preferred stock of the National Grocers' Co., Ltd., had an accumulation of \$26.25 per share in dividends in 1937. To liquidate this accumulation, the holders were offered \$4 in cash and the right to subscribe for three shares of common stock at \$1 per share. A similar liquidation of overdue interest on the mortgage bonds of the Vento Steel Products Co. was accomplished. In consideration of a waiver of this interest, the mortgagee was given the right to buy 9,000 shares of stock at \$1 per share at any time within 5 years. In 1937, a director of Warner Bros. Pictures, Inc., received an option to buy 49 per cent of the stock of a Maryland subsidiary corporation organized by Warner Bros. to exploit patents issued to a former employee, provided the said director spent not less than \$510,000 within the next 5 years in developing these patents. These illustrations demonstrate the almost unlimited possibilities in the use of stock purchase warrants.

**Disadvantages of Warrants.**—In attempting to analyze the possible disadvantages of the use of stock purchase warrants, several points of view must be considered. The unlimited possibilities in the contractual relationship that may be established by their use give cause to wonder whether, in most cases, enough attention has been paid to their consequences. In the first place, determination in advance of the characteristics that a particular warrant should have is sheer guesswork. For example, in trying to be fair to the corporation, to the existing stockholders, and to the prospective stockholders who are to become warrant holders, what periods of time, what ratios, what prices, etc., should be used? Under the most favorable circumstances, this question has no satisfactory answer. Under the circumstances governing the use of many warrants, there is little evidence to show that much thought has been given to the question or to the necessity for finding an answer to it.

From the standpoint of the corporation, we must keep in mind that every outstanding stock purchase warrant gives its holder, under the terms and within the dates stipulated in the warrant, the continuing right to demand the issuance of stock in exchange for cash. Unless the corporation can use this cash to retire senior securities sold with the warrants, the chances are good that it will be supplied with funds that it does not need and cannot use efficiently. The demand for stock purchase under the terms of the warrants would seldom be made except at a time when the corporation was enjoying prosperity. The exercise of the warrant is likely to bring

gain to its holder at the expense of the corporation. In other words, the corporation could, in all probability, obtain any new funds it needed from other sources more cheaply. Paradoxically, however, the existence of a large amount of outstanding warrants may adversely affect its ability to raise capital from other sources.

From the standpoint of the holders of warrants purchased with bonds or preferred stock, it is probable that they have been induced to purchase second- or third-rate securities at the price asked for first-grade securities. By giving too much consideration to the allure of the warrant, the purchaser has failed to give enough attention to the primary security that he has purchased. As a consequence, the acquisition of securities with stock purchase warrants frequently makes speculators out of those who think of themselves as investors. Furthermore, although such purchasers are not aware of it at the time, they usually pay full price for the warrants they buy. To holders of warrants that come in the nature of bonuses or outright gifts, there is little or nothing risked. Hence any gain is a windfall. Absence of gain may not result in a loss. Even where holders of warrants actually exercise them and acquire from the corporation common stock at less than its current price in the open market, the profit may be elusive and may completely disappear before it is realized. Stock, bought from the corporation at \$30 per share at a time when it is quoted on the market at \$40, may quickly drop below its purchase price before its owner disposes of it. As pointed out in the preceding paragraph, the purchase is most likely to take place in a period of prosperity when stock prices are high. Any subsequent decline may wipe out the paper profits of those stockholders who failed to dispose of their stock when it was selling at high prices.

To the holder of outstanding stock, warrants constitute a threat against his stake in the prosperity of the corporation. If the proceeds from the sale of stock according to the terms of the warrants are used to free the corporation from funded debt or preferred stock, present stockholders gain in security. Even in such case, they might lose in income if trading on the equity enhances the return on their stock. If the proceeds from the sale of additional stock should not be used to retire debt or prior securities, the new stock issued may share with the old in any earnings distribution, without bringing into the corporation's coffers commensurate income. The greater the number of warrants outstanding, the greater the threat to existing stockholders. In 1935, the Aviation Corp. had issued warrants for the purchase of approximately as many shares as it had in outstanding stock. In 1929, the American and Foreign Power Co. had outstanding warrants for more than twice the number of its outstanding shares of stock.

**Dilution and Protection of Warrants.**—In the absence of protective arrangements, holders of stock purchase warrants find that their property is subject to the same diluting influences as is that of holders of conversion

**Warrants vs. Conversion Rights.**—While the stock purchase warrants give the speculative investor an incentive to buy bonds that is similar to the incentive afforded by the conversion privilege, the effects of the use of these two devices are entirely different. If no use is made of either, no harm is done. The extensive sale of bonds with warrants at the end of the 1929 bull market makes one wonder if the corporations using them always counted the possible costs. The main differences between the effects of warrants and conversion rights are as follows:

1. The use of the conversion privilege attached to bonds automatically reduces the corporation's debt and its fixed charges. The use of stock purchase warrants has no direct effect upon either debt or fixed charges. The proceeds from the sale of the stock may be used to retire bonds and thereby reduce the fixed charges. On the other hand, no bonds may be retired when stock purchase warrants are used. In like manner, the use of conversion privileges in connection with preferred stock would automatically eliminate such stock and dividends payable thereon. No such effects would follow directly from the use of stock purchase warrants.

2. The use of the conversion privilege at par ratios does not increase the capitalization of the corporation. It merely changes its pattern. Bonds converted into stock at more than par would reduce the capitalization. In the rare cases where bonds are converted at less than par, the capitalization would be increased. The conversion into no-par stock parallels conversion into par stock. Whenever warrants are presented for use, they increase the capitalization of the corporation.

3. Conversion of bonds into stock has no effect upon corporation assets. It merely changes the forms of equities. The use of warrants always brings new money into the coffers of the corporation—whether needed or not. The holder of the warrant, and not the corporation, determines the time for its use. Generally speaking, warrants are most likely to be used when the corporation is prosperous and is not in need of additional outside capital.

4. Conversion of bonds adds to the credit standing of the corporation in two ways: it reduces the debt and increases the ownership equity. The use of stock purchase warrants accomplishes the latter only. In addition, however, the purchase of stock with cash would add correspondingly to the equity capital of the corporation.

**Possible Legal Complications.**—The casual manner displayed in recent years by corporations in the issuance of stock purchase warrants leaves the surface impression that such action can cause no trouble for the corporation in the future. As a matter of fact, all sorts of legal complications may result from the use of stock purchase warrants. Corporations may not have on hand the stock demanded by the holders of the warrants. Stockholders may refuse to authorize the issuance of the new stock necessary for this purpose.

Warrant holders would then be forced to bring suits for damage to obtain redress. In prosecuting such cases, they must prove damage.

Corporations may pass out of existence before warrants are used. Again suits for damages may follow. Reorganizations, recapitalizations, mergers, and consolidations may take place under circumstances that cloud the rights of warrant holders. So long as no holder attempts to use his warrants, corporate managements rest secure. Commercial expediency, rather than legal obligations, dominates their decisions. Sooner or later, the legal chickens may come home to roost.

### QUESTIONS AND SUGGESTIONS

1. What is a stock purchase warrant? How was it first used during the 1920's?
2. How can the warrant be used as a substitute for the conversion right?
3. Distinguish between detachable warrants and those not so classified.
4. How do the purchase and sale of warrants resemble margin trading in stock? What are the time limits on the exercise of warrants?
5. How does the price at which stock could be purchased with the warrant compare with the price of the stock at the time the warrant is issued? Why?
6. Does the price at which stock can be purchased from the corporation remain constant? Why? Why does a corporation issue warrants in selling its bonds?
7. What are the advantages of warrants to their owners? What are the purposes for which warrants are used?
8. What is the difference between a warrant and an option?
9. What is the significance of Woodbury's study of Moody's ratings of securities to which warrants are attached?
10. How are warrants used in reorganizations?
11. How are options used in compensating promoters and underwriters? How would you justify such practices? Account for the common use of management options.
12. Why are options given to new executives? Would you recommend that such options be restricted? Why?
13. How can the sale of warrants for cash be justified?
14. What are the possible disadvantages of warrants: From the standpoint of the corporation? Of the holders of the warrants? Of existing stockholders?
15. Describe dilution and protection of warrants.
16. Contrast warrants with subscription rights.
17. Contrast warrants with conversion rights.
18. What possible legal complications may be encountered by the corporation with warrants outstanding?

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### SUBJECTS FOR INVESTIGATION

1. From any recent issue of Moody's *Manuals*, select (from the blue sheets near the middle of the manual) five corporations with stock purchase warrants outstanding.
2. For what purpose were each of these warrants issued?
3. At what prices and over what period of time may each of them be exercised by the owner thereof?

## PART III

### SECURING CAPITAL

#### CHAPTER XVII

#### PROMOTION

**The Setting.**—In earlier chapters we have described the various kinds of securities used by corporations and some of their interrelationships. Interesting and important though these subjects are, they do not constitute the essence of corporation finance. Rather they should be thought of as the tools that are needed to build the financial structure of American business enterprises. In the hands of the wrong people, these tools become agents of destruction instead of construction. If perchance either dishonest people or honest blunderers undertake to make use of the tools we have been describing, the consequences may work to the disadvantage of other parties having financial commitments to the corporation. Also the so-called “general public” may jump to the erroneous conclusion that financial mistakes and financial manipulation for selfish purposes constitute the necessary result of corporate organization. To avoid these consequences, we find recurrent demands for repressive measures, the enactment and enforcement of which would hamper legitimate and efficient business operations. It is not easy to separate the financial sheep from the financial goats.

Likewise, in considering the subject of promotion, we should keep in mind the proper and desirable economic objectives. The goals of all business organization presumably are the production and distribution of goods and services. Not only is the assembly line in the factory and the mechanism of the market place supposed to be built according to this pattern, but the financing of the enterprise is expected to point to the same ends. It is a well-known fact that there are crooked promoters. There are those whose major interest is the transfer of economic wealth from your pocket into theirs—without attempting to give equivalent value in exchange. There are also many honest promotional efforts that are destined to end in failure. This is more or less inevitable. Promotion deals with the new and the untried. Only trial will demonstrate the presence of error in many instances. In the pages that follow, we must necessarily deal realistically with the subject of promotion.

**Meaning of Promotion.**—Promotion is the process of creating a specific business enterprise. Its scope is very broad, and numerous individuals are



frequently asked to make their contributions to the program. The pattern of promoting a particular corporation may be unique, involving new ideas and novel methods of exploiting them; or it may be prosaic, following slavishly the style that has been in vogue for similar enterprises for long periods of time. Promotion should not be confused with the ordinary processes of business operation. In any specific case, promotion begins when some one gives serious consideration to the formulation of the ideas upon which the business in question is to be based. From this time until a corporation is organized and plans are completed to exploit the idea, the aggregate of activities contributed by all those who participate in the building of the enterprise constitute promotion. When the corporation is organized and ready for operation, the major function of promotion comes to an end. In a very real sense, however, the promotion of any particular business enterprise never ceases. The building and rebuilding process continues as long as the corporation exists. It is understood of course that the term "promotion" applies with equal force to other types of business organization as well as to the corporation. Since the principles involved are common, regardless of the type of organization, the promotion of corporations will be dealt with in the pages that follow.

**The Idea.**—The first stage or step in promotion is the formulation of the ideas upon which it is to be based. Here we find a demonstration of the human side of business relations. In spite of the fact that the corporation is looked upon as an impersonal robot, all ideas are contributed by individual human beings. Promotional ideas originate with single individuals or with small groups. In the nature of the case, the mass of the people, acting together, cannot originate new ideas. It is the function of the mass to test the ideas contributed by individuals and to assure their success by their common acceptance or their failure by rejection.

The ideas upon which a particular business enterprise is based may be embodied in an invention, a process of manufacture, a method of merchandising, a form of organization, a plan of financing, or any one or a combination of many devices for making a profit. The participants in promotion are not necessarily the discoverers of the basic idea. They are the ones who see commercial possibilities in its exploitation. A well-organized campaign may result in the sale to the public of an idea long understood by a few or even long used by other people. The idea may not be new. Promotion may be undertaken for the purpose of exploiting a well-known idea by a new corporation. Experience records many instances in which a failure of one business enterprise may be followed by the success of another that uses the same basic ideas. Here again the human equation provides the difference between success and failure. But the real glamour of promotion stems from the exploitation of new ideas, rather than from the mere introduction of new personalities.

**Need for Investigation.**—New ideas require thorough investigation before too much money is invested in their exploitation. The very newness of ideas invites exaggeration of their importance in the minds of most people. All who participate in promotions are expected to be optimistic. Optimism, by definition, is a tendency to look upon the bright side of a question, ignoring the possibilities of obstacles in the path of any favored program. Because of this weakness of promoters, others must offset it in some manner. Otherwise the infectious optimism of the promoter may be communicated to others who are invited to participate in the enterprise. As a matter of fact, the inherent optimism of the American people makes them good prospects for every conceivable fly-by-night proposition. The average man in the street is not the only victim of worthless and fraudulent schemes. Business leaders and even promoters themselves become the victims of their own gullibility. The death rate among new business enterprises is exceedingly high, largely because so many new projects have no economic justification for existence. "Stop—look—and listen" should become a part of the technique of every new promotion effort. The need for investigation is universal.

**Preliminary Investigation.**—Before any steps are taken to organize a corporation to exploit an idea, various preliminary investigations should be completed. These include the following:

1. *Testing the Idea.*—If the idea is embodied in a mechanical device, it should be tested by the construction of operating models. If a new process is discovered, it should be put to practical tests. In whatever form the idea appears, it should be put to the test of practical operation if possible. Blue-prints and prospectuses may be quite deceptive. Two classes of people claim to possess formulas for solving the world's problems: crazy people and inventors. It is not always easy to distinguish one from the other. Perhaps the only sure method of differentiation is an adequate test. This should prove one essential difference between the ideas of successful businessmen and of those unfortunate individuals who eventually become wards of the state: this difference is that the crazy ideas of successful businessmen actually work, while the suggestions of the other group are merely crazy. It is unfortunate that this other group at times makes attempts at expression of their crazy ideas in the promotion of new enterprises before such ideas have been subjected to an adequate test.

2. *Rights.*—Great minds run in the same channels. A new discovery may be in use already under exclusive monopoly privileges granted by patents and trade-marks. Preliminary investigations should go far to establish rights to exploit new ideas—and ideas new to the promoter of a business enterprise. Rights to be investigated cover not only patents and monopoly privileges, but also such rights as are conveyed by deed, bill of sale, assignment, or any other kind of discovery or transfer. Not only must the validity of a right be established, but its adaptation to the needs of the

new enterprise must be reviewed and passed upon. A lease on real estate might be in due form and entirely valid, but its expiration date may be too near to make the property useful to the new enterprise. Instead of a patent carrying basic rights, it might confer very narrow privileges, which invite constant litigation.

3. *Nature of Competition.*—Few ideas are so novel as not to encounter competition. Competition involves not only a struggle for the consumer's favor in the purchase of products, but similar contests for raw material, labor supply, etc. Competition may be actual or only potential. A successful enterprise whose ideas are not well protected is sure to be imitated. Can it, either by various forms of protection or by superior management, overcome such opposition?

4. *Production Problems.*—Problems involving plant location; sources, adequacy, and quality of raw materials; labor supply; transportation facilities; power available; amount and availability of water and fuel—all merit consideration before promotion plans proceed too far. Every effort should be made to predetermine whether the product can be put into the market with the quality demanded, in quantities that will justify the enterprise, and at costs that will leave a satisfactory margin of profit. Every industrial area commemorates in the form of abandoned plants the demise of good intentions not properly sustained by preliminary investigations.

5. *Sales Problems.*—Public favor is a fickle mistress. At times, it seems that neither rhyme nor reason plays much part in the selection of goods that people buy. Perhaps, in the whirl of the market, the consumer becomes confused and allows the keenest salesman to dispose of his wares. The mousetrap story may have fitted a time when mice were numerous and traps were few; but it hardly describes a market condition dominated by a plethora of traps, poisons, and other means of mouse extermination. Every new product comes into a market that already offers the consumer many ways to dispose of his purchasing power. It must assume the risks of disapproval under the most favorable circumstances. Such risks may be materially reduced by preliminary study. The technique of market surveys has been fairly well developed.

**Formulation of Ideas.**—At the outset, ideas concerning a promotion are likely to be vague. As a result of the preliminary investigations mentioned above, it should be possible to draw tentative conclusions that are much more definite and useful to the promoters. Indeed, that is the purpose of the investigations. Even after all these investigations have been pursued honestly and impartially, there will still remain many unanswered questions. The best that can be expected in advance of actual operation of a business enterprise can be described only in terms of probabilities. But, as the result of preliminary studies, some limitations as well as possibilities should be uncovered. Consequently, it should be possible to formulate

the ideas in sufficiently definite form to enable those concerned with the promotion of the enterprise to proceed to the final steps in the promotion process.

**Assembling the Enterprise.**—Having discovered the ideas upon which a new business enterprise is to be based and having tested their workability, the next step in the promotion process is the assembly of these ideas into a pattern that will look like a going concern. Assembly of the various parts of the new enterprise covers a wide range of activities. Tentative commitments of different kinds are frequently necessary. These include, for example, selection of a site and taking an option for either its lease or purchase; arranging for the construction of a plant and the purchase of equipment; organization of a corporation, probably with a minimum capital; securing of patents; making tentative commitments for personnel, materials, etc. Many things must be done before any attempt is made to sell securities or to provide for necessary capital. Indeed many things must be done in a preliminary manner before the amount of capital needed can be determined. Both the formulation of the financial plan of the new enterprise and the sale of securities are reserved for later discussion.

**Preliminary Financing.**—Before the new corporation is born, somebody must supply the funds with which experimentation and investigation can be financed. The private resources of the promoter and his friends may be used for this purpose. Occasionally, what may be termed a preliminary corporation is organized for this purpose. Under whatever form of organization preliminary operations are undertaken, the aggregate of expenses incurred for preliminary investigations, options, organization expenses, commissions, and property purchases may be considerable. Whoever incurs such expenses takes the risk that the net result of investigations may be negative and that the proposed corporation, when organized, may not assume preincorporation obligations. The corporation, if and when formed, comes into being unencumbered and burdened by no obligations other than those expressed in its charter and in the statutes of the state in which it is organized. After its organization, it may assume such obligations created by promoters, trustees, and others as it sees fit.

**Scale of Operations.**—One of the most important problems involved in promotions is the scale of operations with which the new enterprise is to begin business. In attempting to solve this problem, it is frequently apparent that extraneous considerations play a large part. "Keeping up with the Joneses" is not confined to the purchase of pleasure automobiles. The so-called New England plan recommends that the new enterprise be started on a small scale and that it grow, if growth is desirable, after thorough trial on a small scale, by reinvestment of its own earnings, so far as possible. How different is this procedure from the huge new enterprise that springs full-fledged into a market which it attempts to dominate from the start!

And, at times, how different are the effects, if performance fails to keep pace with promise. If only a promoter and his friends contribute to a new enterprise, its failure may not be recorded by even a ripple on the waters of the financial sea. If a large corporation fails, its backwash may carry with it the savings and hopes of many contributors to its capital funds. It may also seriously embarrass the credit position of all who have had any dealings with it, direct or indirect.

**Incorporating a Going Concern.**—Promotion encompasses not only the organization of an entirely new business enterprise, but includes as well the incorporation and financing of existing unincorporated businesses such as the proprietorship and the partnership. Frequently, incorporation is accompanied by expansion, necessitating plans for securing additional capital. Before incorporation and before any new financing is promoted, the same type of investigations should be pursued as in an entirely new enterprise, except that the subjects investigated may be somewhat different in nature. In fact, investigation of going concerns should be more fruitful of results, since it can be based in part upon the experience of the enterprise to date. On the other hand, the investigation may be more difficult if fundamentally sound conditions have been offset by inefficient management so that a business that should have succeeded has, instead, operated at a loss.

**Promoting a Consolidation.**—The consolidation of existing enterprises into some form of combination is also a promotional project. American industry has experienced great waves of consolidation. Some giant corporations have given good account of themselves and have justified many of the claims of the promoters. Other have demonstrated that they were primarily promoters' consolidations, finding their chief justification in the profits of financing the consolidation. Again, if these promotions are to succeed economically, they must be preceded by investigations to determine their need, convenience, and desirability. The experience of the constituent parts should be useful in such investigations.

Here again the element of size is not a matter of indifference. In some cases, small-scale combinations may not be practicable. This does not mean that there is no limit to the extent of successful combinations, however. The notorious failure of an eastern railroad might have been averted had the corporation kept its eyes centered upon railroad transportation; but, when it absorbed or attempted to absorb every other utility in its territory from the town pump up, it found the sheriff waiting to write the final chapter of its life history. As a general rule, it is probably true that more promotions fail because they undertake too much than because they try to accomplish too little.

**The Human Equation.**—The very idea of promotion suggests a bringing together of various interests with the expectation of changing the form at least of their existing claims. Options are secured from property owners;

security purchasers transfer cash for stocks and bonds; etc. New relationships are established, largely on faith. In promotion, valuation is less a matter of cold impersonal calculation than it is in dealings with established enterprises. All business relations are based largely upon confidence. This is particularly true of those established in the process of promoting a new enterprise. Confidence building is largely a matter of understanding the factors that motivate human decisions. Successful promotion calls out the most effective kind of sales ability. Order takers may be trusted to wrap up the thing pointed out by the purchaser; ordinary salesmen may succeed in disposing of the commodity with which the purchaser is familiar; but it takes supersalesmanship to sell the ideas that have not yet been put into concrete form but exist only in the word pictures painted by the promoter. Some call this diplomacy. Under whatever label, it is essentially an ability to solve the human equation.

### THE PROMOTER

**Definition.**—A promoter is an individual who undertakes to establish a business enterprise. He is primarily an organizer who brings together the parties interested in the enterprise as sellers, buyers, or managers. Unfortunately, the name “promoter” is associated in the minds of many people with crookedness, fraud, and sharp dealings. It is true that there are many charlatans whose stock in trade is worthless securities; but charlatanism is a characteristic by no means limited to the field of corporate promotion. No occupation or calling is immune. Ofttimes, however, promoters are credited with fraudulent intentions where none exist. Although promotion implies uncertainty and experimentation with the new and untried, if failure results, the promoter is asked to take the blame. Be that as it may, it is a well-recognized fact that no worthwhile enterprise was ever started without the services of a promoter.

A successful promoter is a creator of wealth. The ideas with which he deals may be neither profound nor complex. Nevertheless they escape the notice of all except the rare individual who possesses the qualifications of the promoter. Once he has called them to the attention of others and has made their results available for common use, many people wonder why they did not think of the commercial possibilities of the ideas first. A successful promoter is an economic prophet. He is able to visualize what does not yet exist and to organize business enterprises to make the products available to the using public. A promoter is not only an individual, but he is distinctly individualistic. Indeed, he frequently “travels alone” for a considerable time because of his inability to convince others of the soundness of his ideas. Interesting but true stories are told about many of our essential products in common use, to the effect that, when they were first proposed, skeptics did

all they could to discourage the promoters of these products from persisting in their efforts to produce and market them.

**Qualifications.**—The foregoing analysis suggests that promoters possess mental equipment not shared in like proportions with other people. The outstanding qualification of a promoter is the possession of a fertile imagination—the power to combine the products of past experiences into new or modified forms. To be successful this imagination must be of a practical turn. It must lead to a product that will fill a need. The need itself may be a part of the imaginative process. Not only must the promoter be able to exploit his ideas, but he must be able to induce the acceptance of his products by those who are expected to buy them. This implies that the promoter is a good salesman. Before he can be in a position to market his goods, he must market his ideas in order to enlist the financial and other support needed to get his enterprise started.

Organizing ability is essential to successful promotion. Not only must the promoter take the initiative in calling the possibilities of his ideas to the attention of others, but he must be able to induce them to work together in planning to exploit them. Since it is to be expected that many who will be approached will give a negative response, the promoter must have the courage of his convictions and must be persistent in pressing his claims, even against expected skepticism and open opposition. Since the concept of promotion usually involves something new, it will exist at the outset only in the mind of the promoter. He must therefore be able to inspire confidence in himself since he can seldom have much of a tangible nature to convince those whom he invites to participate with him in the venture. The line between so-called “pure” imagination and practical ideas cannot always be easily drawn. For that reason, the promoter’s job of convincing people that his project is practical is not an easy one.

Because so many factors must be considered in a promotion project and because new trails are being blazed through the economic wilderness, there must be the exercise of judgment and the balancing of opposing forces in every promotional effort. These concepts seem to be in conflict with the qualities of imagination, initiative, and enthusiasm. As a choice between enthusiasm and balanced judgment, the promoter is expected to possess a larger measure of the former than of the latter. Judgment is essential to successful promotion. Others than the promoter may be called upon to supply it.

**Types of Promoters.**—There is no specific training school for promoters. Knowledge alone will not equip a man for successful experience in this field. Originators of mechanical devices are seldom successful in promoting their exploitation. To a peculiar degree, promoters must possess the elusive quality sometimes called “business sense.” Promoters are usually classified into several groups as follows:

1. *Accidental Promoters*.—This group includes the large number of organizers of small business enterprises who see, or think they see, commercial possibilities in some idea. Literally thousands of such individuals from every walk of life take at least one fling at the organization of a business enterprise. Most of them buy commercial and industrial tombstones with their capital, their enthusiasm, and their energy. Their operations, happily, are confined to the localities in which they live, so that their failures are of relatively small import. Occasionally one succeeds and justifies his investment and that of his friends who join with him in the enterprise.

2. *Local "Professional" Promoters*.—Some local lawyers, bankers, and business "magnates" are always on the lookout for promotional opportunities. They initiate new enterprises, incorporate and expand old ones and, at times, effect combinations of local enterprises. Local inventors and others with schemes for making money usually seek the advice of a lawyer, banker, or businessman known for his willingness to encourage a new enterprise. The invitation for promotions is thus laid at the feet of the local "professional" promoters.

3. *Engineering Firms*.—A few outstanding engineering firms of national repute find promotion a lucrative occupation. At the outset, promotion may have been accidental with them, incidental to other activities. With some of them, the side issue of promotion has become their major interest. Manufacturing corporations sometimes promote new enterprises as an outlet for their products. Success breeds success, and other enterprises may be offered to them for promotion.

4. *Business Executives*.—Combinations of competing or complementary business corporations may result from the initiative of the head of one of the corporations. He may see opportunities for greater profits through price control or economies of operation, and, consequently, he may promote a combination of competing or complementary business units. The promoter of this type may stop with one effort or may give part or all of his attention thereafter to such activity.

5. *Financial Promoters*.—Financial institutions, or affiliated groups of banks, may stimulate promotion and even direct it at a time when the market for securities favors new flotations. The financial profit from such issues induces financial institutions to seek opportunities for the sale of new issues of stocks or bonds or both. Sometimes, under these conditions, industrial and commercial reasons for promotion give place to financial reasons.

**Promoters of Combinations.**—The romance of spectacular promotions has become a part of American economic history. The activities of some of them provide more fascinating reading than most purely fictional literature. In the field of industrial promoters, John D. Rockefeller takes high place for the manner in which he succeeded in effecting control over the petroleum industry. Among his contemporaries who are classed as professional pro-



moters, J. H. and W. H. Moore were active around the turn of the century. To their credit must be recorded numerous important combinations. Among banker promoters, none have since matched the success of J. P. Morgan the elder. His signal success in bringing together conflicting interests to form the United States Steel Corp. stamped him as a supersalesman. Even some of his successful promotions, which soon developed into business failures, such as the International Mercantile Marine Co. and the United States Shipbuilding Corp., have failed to dim his brilliance as a successful banker promoter. Engineering firms that have made notable records in promotional efforts are probably headed by Stone and Webster.

**Legal Relations of Promoters.**—Because of the existence of widespread frauds resulting from promotion activities, state laws have been passed to place more or less definite liabilities upon promoters. The Securities Act of 1933 had this as one of its major objectives. For example, a promoter may not secure for himself a secret profit. He must act in a fiduciary capacity toward the corporation he is promoting. Although his acts are in the nature of agency, he is not an agent in the eyes of the law because, before the corporation is chartered, no principal has yet been created. He may be the agent of individuals for whom he is acting in the organization of a corporation. Or he may be acting for himself, using his own financial resources. In making the contracts and other preliminary commitments described earlier in this chapter under the caption of Assembling the Enterprise, the promoter is understood to be acting in a manner that is not quite sanctioned by law. All such arrangements are almost always contingent upon the successful organization of the corporation and upon its assumption of the obligations created by the promoter.

Sometimes the promoter needs legal protection since the corporation, after its creation, may elect to ignore or to reject the preliminary arrangements that the promoter has made. It is not bound to assume any preincorporation obligations of any kind. The time, energy, and money that a promoter invests in preincorporation activities may be sacrificed in case he is not able to satisfy the parties at interest. Many attempted promotions, particularly those involving corporate consolidations, have left the promoter and sometimes his resources on the scrap heap of unsuccessful attempts.

The promoter is frequently vulnerable in his relationships to those who supply the funds for preincorporation expenditures. For example, if patents, options, leases, contracts, etc., are taken in the name of others than himself or some organization that he controls, he may be frozen out even though the new corporation should take them over after its organization is completed. At least he is at the mercy of those who control the corporation and the preincorporation arrangements. If the promoter keeps all such arrangements within his personal control, he is at least in a strong bargaining position when the corporation is organized. If for any reason it refuses to

take over any commitment that he has made, he may be able to market it elsewhere.

**Compensation.**—A promoter deals in futures. He must profess faith in his enterprise in order to communicate it to others. For that reason, he is forced to take as compensation for his efforts, and sometimes for his cash contributions as well, residual equities of the corporation. Should he insist upon payment in bonds or preferred stock, he would thereby exhibit a lack of faith that might be fatal to the whole enterprise. Hence American promoters almost always receive a block of common stock, representing final claim against assets and earnings. In English practice, founders' shares, previously described, are commonly used. The amount of common stock received ordinarily by promoters of American corporations is certainly out of proportion to their capital contributions and may appear to be handsome payment for their services. But the risks of promotion are great. Failures—not all due to the faults of promoters—are common.

Sometimes a promoter is paid for his services with an option to purchase stock at a stated price. These options constitute a claim against the future success of the corporation. Should the corporation fail, the option will not be exercised. Only in case future prices, within the period covered by the option, promise a profit will the promoter exercise his right to buy stock from the corporation.

It is not uncommon for a promoter to receive his compensation in cash and stock. Most of them hope to get back in cash at least what they have put into the enterprise in preincorporation expenses, plus something tangible in part payment for their time and effort. The "profit" part of the compensation is almost invariably in the form of common stock or warrants. The amount of common stock that is given to promoters varies with the circumstances. A customary profit for promotional activities alone seems to be around 10 per cent. Bankers' commissions and bonuses in the form of stock are additional. In many instances, the total costs of promoting a corporation may be approximately half of the issued stock. If the promoter is also the inventor and if he finances the preliminary costs, he may receive as much as 51 per cent of the common stock. Indeed he may insist upon this proportion in order to ensure his continued control of the enterprise.

Viewed in terms of the head-line successes in corporate promotion, the amount of a promoter's profits may be considered exorbitant by other stockholders. They may be in specific instances. But offsetting the publicized profits of conspicuous successes must be considered the infrequency of such successes. The chances of failure are very great since the death rate among business enterprises is very high. On the average, the amount of promotional profit is probably not nearly so large as it is assumed to be. Even when the corporation develops unusual earning power over the years,

it is not likely that the promoter will have retained his stock in order to take advantage of the resulting profits.

### THE PROMOTER'S ASSOCIATES

The success of a well-planned promotion depends not only upon the contribution of the promoter, but upon various experts who aid him in his work. The promoter furnishes vision, optimism, imagination, and enthusiasm—all essential qualities in the launching of a new enterprise. If the business is to have a chance to succeed, however, other qualities, less romantic, must be supplied by the promoter's associates. Among these associates the most useful are the following:

**Technical Experts.**—Depending upon the services to be rendered, the term "technical expert" has very broad meanings. It may mean the geologist in oil ventures, the metallurgist in mining, or, in other cases, the civil engineer, the chemist, etc. Nor is the term "expert" confined entirely to the physical sciences. Perhaps what is most needed in a particular case is the services of a market analyst, a banker, or a man with successful business experience in the line of business under consideration. The promoter lacks the technical knowledge to answer many questions that arise in the promotion process. Even though he had the time and the inclination to acquire such knowledge, it is not likely that he can gain in the long run by such application of his time. Then, too, if he possesses the other qualities necessary in a successful promoter, he may lack the balanced judgment expected of a technician. Furthermore, the cost of expert services is not ordinarily high.

As a matter of fact, it is probably fortunate for both the promoter and for his subsequent associates when he hires the services of independent experts. If they are truly independent, they will serve as a check upon his enthusiasm instead of giving him the "yes-man" kind of support that helps him but little if it does not actually do harm to the enterprise. In seeking expert advice, the promoter should solicit it from those who are jealous of their reputations and who therefore present only such conclusions as their unbiased study of the available facts warrants. If the facts do not justify the organization of the enterprise under consideration, this is an even more important conclusion than a statement that is not borne out by the facts. It is understood of course that each expert shall study and report upon the conditions within his own field of operation. It must be kept in mind also that not all questions can be answered by a preliminary investigation. The conclusions of all experts engaged in a specific project will still leave open the question, "What shall be done about the promotion of the enterprise?" This question must be answered by others than the experts. Their conclusions are evidence but not the final judgment.

**Technician as Promoter.**—Inventors are notoriously poor businessmen. Technicians also frequently lack business sense. Their work makes them conservative. They are accustomed to weigh all sides of a question before arriving at a decision. Business judgment involves information, but it also involves decisions, sometimes arrived at more quickly than an analysis of all facts in the case would permit. When a technical expert signs his name to a report, he commits his professional reputation to the conclusions contained therein. Recognition that a few mistakes would ruin this reputation makes him cautious about endorsing the enthusiasm of the promoter. The same caution prevents technical experts from becoming successful promoters. Promoters go wrong less often by depending upon the studies and advice of experts than they do when they “read between the lines” of experts’ reports. While technicians are notoriously poor promoters, promoters are equally notorious in their shortcomings as technical experts. Each can properly supplement the other.

**Pseudo Experts.**—Capitalizing on the confidence that the security-buying public is accustomed to place in the investigations and reports of technical experts, promoters of fraudulent securities have quoted glibly from the opinions and recommendations of so-called “experts” who, if they are not fictitious persons, will endorse anything for a consideration. The paid testimony of these pseudo experts should not be confused with the more cautious conclusions of the real experts described above. In many instances in past promotions, it was evident that “our geologist” or “our chemist” who was quoted anonymously in support of the extravagant claims of some promoters of blue-sky stock were mere figments of the imagination. It is to be hoped that the Securities and Exchange Commission will continue to insist upon the quotation of the names of all who participate in the promotion of corporate securities and upon their acceptance of reasonable responsibility for their representations. By this means the damage that can be done by the testimony of pseudo experts will be minimized. There is no place for them in legitimate business activities.

**Accountant.**—Accounting records should not only furnish a history of past business operations; they should be indispensable in charting the future course of business. While the accountant would appear to be of little use to a promoter of a new enterprise, any promotion involving a going concern must start from the accountant’s picture of the business. Furthermore, the auditing of accounts involves more than arithmetical computations and verifications. The auditor, in casting a retrospective glance over the accounts of the corporation under review, not only looks for mechanical errors, but is in a position to detect mistakes in accounting principles and procedure.

**Scope.**—The scope of the accountant’s usefulness to the promoter is very elastic. His audit of the books of a going concern may be of invaluable aid

in appraising it. In addition, he is equipped to make special investigations that use the records of the corporation as a source of material. Whether or not he will attempt to forecast the future of the business, he can at least call attention to significant past conditions, disclosed by the records to one able to read them intelligently, but generally overlooked by others because hidden in unusual places or under names that are not descriptive. The accountant may hesitate to undertake appraisals as such, but his records and audits are useful to those who fix asset values.

**Reputation.**—"Audited by a certified public accountant" is a label with sufficient potential value to make all accountants jealous in guarding it against adulteration. Accountants have within their power the education of business executives to the preparation of more honest and intelligent reports by standing firmly against attempts of promoters of fraudulent securities, and others with ulterior motives, to trade upon the reputation of accountants in attaching the above quotation to their nefarious literature. The auditor who signs the report understands the limitations of his audit. But the public accepts his audit as a blanket guarantee of all statements and items contained therein. The cloak of respectability is the property of the accountant and should not be sold or rented to the unscrupulous promoter who hides his disreputable practices under it.

**Attorney.**—The third type of expert needed by the promoter is the lawyer. Business operations consist of a series of contracts. The promoter particularly is making new contracts, some of which may not be of the stereotyped sort. He needs an attorney to safeguard his interests and make sure that his rights are protected and his obligations clearly defined. The promoter of a business to be incorporated is coming into contact with a whole series of laws that only a lawyer can understand and apply to a given set of conditions. As a general rule, many of the men with whom the promoter deals are shrewd businessmen who know the rules of the game thoroughly. Legal relations in business are not always what they seem. Not only a lawyer but one who is partisan to his client is needed to protect the promoter's interests. A contract drawn by the attorney for the other party to the transaction may be in good legal form, but it is likely to favor the other party. If both parties' interests are guarded by partisan lawyers, justice is more likely to be served.

**Functions.**—The legal profession has never quite divorced itself from the notion that a lawyer is a businessman.<sup>1</sup> He may be, but a knowledge of law does not make him such. He may know all the legal requirements of business transactions, yet lack the business sense necessary to discriminate

<sup>1</sup> The genesis of such a notion reaches back to the beginnings of the common practice of making investments for clients. An early treatise on investments is authority for the pronouncement: "No person is able to judge of the eligibility of investments generally without some knowledge of the law." [Ward, Robert Arthur (solicitor), "A Treatise on Investments" (London, 1852), p. 3.]

among alternatives. His legal judgment may be much better than his business judgment. Therefore, promoters should use the equipment that lawyers possess but should not take them too seriously outside the fields of their specialty. One of the causes of failure of promotions is neglect to comply with some legal requirement or to draft properly options or other contracts. Herein lies the chief usefulness of lawyers as associates to promoters.

**Financial Associates.**—Every promotion must be financed. Occasionally the promoter supplies the capital needed to exploit his ideas. In important promotions, this happens so seldom that such rare occasions can be disregarded. Occasionally, friends of the promoter supply the capital. This, too, is relatively infrequent in actual practice in the promotion of larger enterprises. For the most part, the promoter is dependent upon that unidentified group that we call capitalists for the funds with which to finance his project. Since those people who are able and willing to advance the necessary capital are unknown to him, he must depend upon the assistance of bankers in obtaining the necessary funds. Consequently, both the banker and the capitalist may be considered to be the financial associates of the promoter. Because of the importance of the banker's contributions, a discussion of his services is reserved to later chapters.

**Importance of Promotions.**—In the past, the promoter has been given a place in American corporation finance that was more important and occasionally more lucrative than his services justified. Without the process of promotion, there would be no new enterprises and economic progress would be distinctly limited except as indicated below. Such promotions as have operating enterprises as their objective should be fostered and encouraged. Such as have only financing profits as their major objective we can readily dispense with, to the advantage of all but the narrowly selfish interests of promoters. In numbers at least, both types are likely to be less emphasized in the future than in the past. The tendency toward stabilization of existing corporate enterprises is likely to continue. New processes and important new products will probably be developed more often by existing experimental laboratories than by independent inventors, the exploitation of whose inventions demands the organization of new corporations. While new corporations will still be organized, their importance may decline relatively as our economy matures.

Insistent demands from many quarters will continue to make the role of the fraudulent promoter more difficult than it was in the past. Even though his presence was known heretofore, we relied upon the doctrine of *caveat emptor* to minimize the number of his victims. This doctrine receives less support than it formerly did. Once we have embarked upon a program of restricting the creation and the sale of blue-sky securities, it is unlikely that we shall ever issue the open invitations that formerly resulted in a continuous

flood of worthless stocks. This does not mean that all stocks to be issued hereafter will be bargains. The fraudulent ones will be less numerous at least.

While the process of promotion is essential to economic progress, we should not assign to the promoter too important a role in our economic drama. The starting of the business is not nearly so significant as its continuous successful operation. A world filled with promoters would keep us interested in their successive brain children. It would hardly supply us with the quantity and quality of goods and services needed for our continued well-being. Promotion is one of the spot-lighted actors in our economic drama. But the operation of our corporations—after their initial organization—carries the real theme of our economic system. This does not mean, however, that public interest in promotion projects should be neglected. Promotion mistakes adversely affect our attitudes toward the continuance of private enterprise and individual initiative. Elimination of abuses and minimization of errors in the promotion of new corporations will relieve existing enterprises of much unwarranted criticism that comes from those who impute promoters' mistakes to all business leadership. We need to strike a balance between encouragement to promotion of needed business enterprises and repression of those that are most likely to result in profits to promoters only.

### QUESTIONS AND SUGGESTIONS

1. What are the proper goals of business organization?
2. Why is the failure rate of new promotions high?
3. Define promotion, and state its functions. Where does it start? Where does it end?
4. Why do new ideas need investigation before they are exploited?
5. What kinds of investigation are needed? Who should make them?
6. What is meant by assembling the enterprise?
7. Who is responsible for the preliminary financing?
8. What scale of operations should be undertaken by a new enterprise? Why?
9. Does promotion apply only to new enterprises? Explain. What kinds of promoters has American business experienced?
10. What are the qualifications of a successful promoter? What do you understand by imagination?
11. Is the promoter expected to possess balanced judgment? Why?
12. What are the common types of promoters?
13. Name some outstanding promoters of combinations.
14. What are the legal relationships of promoters?
15. How is the promoter compensated?
16. Who are the promoter's associates? What should be their chief functions?
17. Who are pseudo experts? Who uses them?
18. How important are promotional efforts in the development of American business?
19. What alternative procedure may produce new products and new processes in the future?

## SUPPLEMENTARY READINGS

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## SUBJECTS FOR INVESTIGATION

1. Select an idea which you think capable of exploitation in the promotion of a new corporation. List the specific questions about this idea which should be investigated before the corporation is launched.
2. What preliminary financing will be needed and for what purposes?
3. What amount of capital will probably be needed to launch the corporation, and how do you recommend that it be raised?



## CHAPTER XVIII

### THE FINANCIAL PLAN

**Meaning.**—By the financial plan of a corporation is meant its pattern of stocks and bonds outstanding. This pattern is of great significance at the time the corporation is organized. In this respect, the formulation of the original financial plan is a function of promotion. When the corporation is organized, someone must determine in advance the amount of capital needed to start it as an operating concern. Then plans must be made to secure this capital in such manner that the long-run needs of the corporation will be best served. While the formulation of the financial plan is a function of promotion, the plan should not be thought of solely in connection with the promotion process. Long after promotion is forgotten, the financial plan will aid greatly in determining either the success or the failure of the corporation. Even the original formulation of the plan should be conceived in terms of the long-run needs of the corporation, rather than in terms of the easiest method of obtaining the original capital.

**Importance.**—One of the most prolific sources of failures of business promotions is a defective financial plan. The plan adopted may fail to provide sufficient capital to meet the needs for both fixed and circulating capital, particularly the latter. The road to business oblivion is strewn with shells of corporate structures that had sufficient funds to secure a plant but not enough to equip it and conduct operations successfully. The plan may be defective also in the obligations assumed by the corporation without established earning power.

Those who formulate the financial plan of a corporation should keep in mind that there is only one justification for its existence: *viz.*, to provide the funds for an operating enterprise. Promoters and security salesmen who lose sight of this objective produce results that undermine confidence in economic processes by centering attention upon the evils of financial manipulation, which in turn are interpreted to be weaknesses of the general business structure. This does not imply that fraud is always or even generally intended. Rather, unwarranted optimism and lack of information are more often the causes of faulty financial plans: optimism about the possibilities of an untried enterprise, and lack of information about its specific needs and limitations. It is hardly to be expected that promoters and security salesmen should be operating experts. For that reason, their judgment should not weigh too heavily in the formulation of financial plans.

**Basis of Plan.**—An adequate financial plan is always formulated in terms of certain fundamental economic and financial principles which should be observed in drafting it. Among the more important of these principles are the following:

1. *Simpleness of Purpose.*—The financial plan should be drafted in terms of the purposes for which the enterprise is organized. No corporation, however liberal its charter, should “shoot at the horizon.” Its management should have definite goals in mind and know pretty well how to reach them. The tendency in recent years has been to broaden the purpose clause of corporate charters in order to afford flexibility in operation. Within reasonable limits, this flexibility is desirable. It gives the management the right to modify its products to meet changed conditions. Even in such case, however, at no time is a broadside of operations on many fronts justified. The financial plan, as originally drafted, should not be based upon an assumption of trying to supply capital for a great variety of purposes.

2. *Planning Foresight.*—The financial plan is expected to reflect the needs for capital. Capital requirements are determined by the scope of operations. Foresight must be used in planning the scope of operations in order that the needs for capital may be estimated as accurately as possible. This is not always a simple task. For example, in the exploitation of a new invention, it is always difficult to predict the probable demand for the product. Even the best of market surveys can produce only tentative conclusions. But the presence of difficulties does not excuse the promoters from using foresight in drafting their financial plans. All available tools should be used to their best advantage in building the new corporate structure.

3. *Intensive Use.*—Wasteful use of capital is almost as bad as inadequate capital. The usual optimism of promoters tends to invite a scale of financial planning that may not be justified from the results. An adequate financial plan always assumes that necessary capital needs will be met, but that available capital will be used sparingly where it is not needed. In determining the amount of capital that can be used effectively, a proper balance between fixed and circulating or working capital should be maintained. A surplus of either might not be able to offset a shortage of the other. It might be difficult at best to exchange one for the other.

4. *Contingencies.*—No business management can assume that it will always have smooth sailing. Contingencies should be expected, and the financial plan should be so drafted that it can be adapted to meet them as they arise. This does not mean that a surplus of capital shall be kept idle against the time that it may be needed to meet an unforeseen contingency. Rather it means that those responsible for the promotion of the enterprise should undertake first to forecast what kinds of contingencies the corporation is likely to be called upon to face. It is not unusual for optimistic promoters to disregard the possibility of interference of any kind and to formulate a

plan which is so inflexible that the appearance of some unforeseen obstacle creates a major disaster... Once these contingencies are visualized, it then becomes necessary to take them into account in the formulation of the financial plan.

5. *Liquidity*.—Closely associated, though not synonymous, with the question of contingencies is the problem of liquidity. Again what is needed is a proper balance, based upon the probable needs of the particular corporation. Adequate liquidity will give it the degree of flexibility necessary to absorb the shocks of its normal operations. Less than is needed may cause serious embarrassment which may lead to loss of control or even failure. More than sufficient liquidity invites practices that are likely to be wasteful. The amount of liquid assets needed by corporations is a function of several variables. The size of the corporation, its age, its credit standing, and the stage of the business cycle are all of great importance. Even the nature of the business will be a determining factor in estimating the needs for liquidity. For example, the proportion of total capital that should be kept in liquid form for a hydroelectric plant is very small, in comparison with the proportions needed for a financial institution. Even among industrial corporations these ratios vary a great deal. One study of 389 large corporations with total assets of \$24,000,000,000, out of the \$105,000,000,000 reported to the Bureau of Internal Revenue, showed variations from 4.4 to 31.3 per cent of total tangible assets. Cash represented 54 per cent of the total liquid assets; tax-exempt securities, 15 per cent; and other marketable securities, 26 per cent. In general, the larger corporations carried a higher percentage of liquid assets than did the smaller corporations.<sup>1</sup>

**Fundamental Relations.**—In setting up the financial plan of a corporation, several relationships, fundamental to the success of the plan, must be observed. Among the most important are the following:

1. *Financial Pattern and Corporate Conditions*.—First must be considered the needs and financial condition of the corporation. The mere fact that the market will buy bonds is no justification for their use, if the corporation's interests will be best served by the sale of stock. From the corporation's standpoint, it should issue first the weakest security the market will absorb—reserving the better protected types for future use when the market may be less favorable. Not only the present interest of the corporation but its future as well must be provided for.

2. *Market Conditions*.—Whatever the desires of the corporate management, it cannot overlook or disregard prevailing fashions in security markets. "The public is always right" applies here as elsewhere. If the investing public feels pessimistic and will buy only bonds, it is useless to offer it common stocks. On the other hand, if it demands a share in the growth

<sup>1</sup> Dunham, C. F., "Secondary Reserves of United States Industrial Corporations," Ph.D. thesis, Urbana, Ill., 1935.

of industry, stocks alone offer to supply such demand. Some bond offerings in eras of prosperity go begging unless sweetened with conversion privileges or stock purchase warrants.

In offering securities in the investment and speculative markets, unfamiliar financial devices create sales resistance. Some years ago a bond issue based upon the stable-money principle was offered for sale. Its unfamiliar character, whatever its merits, militated against its success. After futile efforts to force it upon a reluctant market, it was finally withdrawn.

The suggestion that market conditions must be considered in issuing securities does not invalidate the previous statement that the interests of the corporation are paramount. It is merely a caution against the offer of types of securities that will not appeal to buyers at a particular time. If a corporation cannot sell stocks, as it desires, perhaps it should refrain, if possible, from any new security issues until market fashions change.

3. *Asset Values*.—A corporation is limited, in its choice of securities, by the value of its assets. If it has few or no tangible assets, it cannot depend upon mortgage bonds. In general, the actual value of its fixed assets should exceed by 25 to 50 per cent the amount of mortgage bonds to be issued. The character and stability of asset values govern also. If the value of assets changes rapidly, bonds should be used sparingly. In this paragraph, "actual asset values" are emphasized. Cost of assets may or may not be an adequate measure of value and therefore should not be given prime consideration.

When preferred stocks are used, they should not exceed in amount the unpledged value of fixed assets plus the value of net current assets. Preferably, the amount of stock or other contingent charge obligations should be enough less than this combination of values to permit a margin of safety in case of value shrinkage.

The amount of common stock issued is sometimes considered to be independent of asset values. If no-par stock is used, the number of shares is more or less immaterial. But the advertised values of common stock, plus contingent obligations, plus fixed obligations, should not exceed the actual value of tangible assets plus that of intangibles.

4. *Earning Capacity*.—Asset values have particular importance to financial plans when a corporation is ill. They determine the liquidation equities of security holders, if failure, rather than success, is stamped upon the corporation's banner. The corporation in good health looks to its earning capacity to justify its financial plan. A good financial plan frequently is the best health insurance a corporation may acquire. In general, the following rules should be observed in relating types of securities to earning capacity:

a. Fixed charges, including interest and sinking-fund payments, should be well below conservatively anticipated net earnings. The usual recommendation places minimum expected earnings at twice the amount of fixed charges that a corporation may safely assume. Presumably, it is thought that even conservative optimism should be discounted at least 50 per cent.

b. Dividends on preferred stock, and other contingent charges, may be allowed to absorb a somewhat higher proportion of anticipated net earnings, after fixed charges, perhaps three-fourths. While such obligations should be met, if possible, failure to pay them will not precipitate bankruptcy. It may, however, seriously embarrass the credit standing of the corporation.

c. Along with minimum earnings, regularity is important. If a corporation's business is of such nature as to produce highly fluctuating and uncertain earnings, only common stock should be used.

From the above discussion of the relation of earning capacity to the financial plan, it is readily apparent that corporate managements in determining the amount and kinds of securities to be issued must make heroic efforts to forecast future earnings. The difficulties involved in such attempted forecasts recommend the use of common stock only for most new corporations—or at least common and preferred stocks, but no bonds. From what has already been said about preferred stocks, however, it should be clear that they are frequently used without adequate justification.

The table opposite shows the wide variations in earnings per common share of corporations selected to show differences in earnings regularity.

The period selected for study started with the boom year of 1929, followed through the depression years of the 1930's, and continued through the war prosperity of the late 1930's and the early 1940's. The differences in earnings per share are very marked. The conclusions to be drawn in terms of the effect of these earnings upon the character of the financial plans are obvious.

d. Average earnings are useful for forecasting purposes only to the extent that the averages used are "representative" for the purposes to be served. Generally speaking, the broader the base for the averages, the less meaning the averages have for specific industries and corporations. Nevertheless, studies of average earnings help to understand trends and limitations.

Epstein finds the average net earnings, after taxes, for 3,144 large corporations for the 10-year period 1919 to 1928, to be 9.2 per cent. The range of average earnings for each year of the period was 12.8 per cent in 1919 to 2.4 in 1921. Between 1922 and 1928, the range was from 8.6 to 10.2 per cent. When classified by industries for the prosperous year 1928, eight industries show earnings of less than 5 per cent, and three show over 25 per cent upon their invested capital. The extreme range was from 1.3 to 27.3 per cent. In the depression year of 1921, the extreme ranges by industries was from a net loss of 29.2 per cent to a net profit of 29.2 per cent.

Year	Diamond Match Co.	American Sugar Refining Co.	International Harvester Co.	American Locomotive Co.	Parke, Davis and Co.
1929	\$0.61	\$7.77	\$7.11	\$5.41	\$1.76
1930	1.37	5.58	4.55	1.41	1.58
1931	1.30	2.23	(d)1.03	(d)8.53	1.26
1932	1.57	2.62	(d)3.14	(d)9.22	1.18
1933	1.64	3.67	(d)1.79	(d)5.12	1.41
1934	1.76	3.56	(d)0.41	(d)5.91	1.80
1935	1.97	0.94	3.28	(d)5.06	1.81
1936	1.65	2.67	5.78	(d)1.70	1.88
1937	1.62	2.21	6.31	4.75	1.85
1938	1.60	(d)6.10	3.00	(d)4.90	1.77
1939	1.64	(d)0.84	1.71	(d)4.45	1.89
1940	1.51	0.65	4.11	0.50	1.67
1941	1.57	1.71	5.87	4.12	1.64
1942	1.64	1.41	4.95	3.37	1.29
1943	1.61	2.00	4.70	3.03	1.68
1944	1.63	5.01	4.61	4.58	1.55
1945	1.70	3.17	4.42	2.53	1.59

Year	American Snuff Co.	United Shoe Machinery Corp.	U.S. Industrial Alcohol Co.	Wheeling Steel Corp.
1929	\$4.26	\$3.33	\$12.63	\$13.30
1930	3.76	3.88	(d) 5.07	(d) 0.01
1931	3.82	3.31	(d) 4.91	(d)13.51
1932	3.59	2.94	(d) 3.54	(d)14.38
1933	4.12	2.42	3.56	(d) 6.63
1934	4.06	3.93	4.04	(d) 4.52
1935	3.29	3.66	2.16	3.12
1936	3.32	4.29	(d) 0.20	4.71
1937	3.13	4.30	(d) 1.17	4.11
1938	3.32	3.82	(d) 1.71	(d) 2.55
1939	3.03	4.12	0.20	6.38
1940	2.66	3.88	0.57	6.63
1941	2.63	3.23	2.13	11.71
1942	2.29	4.34	5.30	4.61
1943	2.19	3.44	3.06	4.43
1944	2.12	3.37	4.45	4.51
1945	1.83	3.16	4.49	3.75

(d) means deficit.

Of the 2,046 large manufacturing corporations, 95 per cent earned a profit on their capital in 1928 against 70 per cent in 1921. The highest rates of earnings occurred in corporations with capital of \$250,000 to \$500,000.

Consumers' goods industries enjoy both higher and steadier earnings than producers' goods industries.<sup>1</sup>

The average rate of earnings on the total net assets of 699 corporations studied by Paton, for the years 1927 to 1929, was 8.4 per cent; the average rate on the equity of the common stockholders was 9.2 per cent. The annual rates on total net assets were 8.2 in 1927, 8.8 in 1928, and 8.0 in 1929.<sup>2</sup>

Industrial averages serve other purposes than to set the exact pattern for particular financial plans. Frequently they help to show what is happening to earnings in wide industrial areas. Indirectly they help those responsible for financial plans of specific corporations to anticipate changes therein. As in most other economic relationships, it is not safe to assume that a plan which once fitted the needs of a specific corporation will always meet its requirements. For example, it was formerly believed that railroads and public utilities could safely use bonds, whereas industrials should issue only stocks. Recent financial history must have shocked those who hold such beliefs. Perhaps the better test is related to earnings and not to industries. Bonds can be used safely in mature industries by corporations whose earnings are stabilized. There is no finality about this statement. Maturity is relative. It does not imply great age. On the contrary, an old industry may have passed the age of maturity and may be in the age of senility. Whenever it reaches the latter stage, its bonds cease to be high-grade investments.

5. *Control*.—A final factor to be considered in determining the character of the financial plan is that of allocating the balance of control of the corporation. For the most part, the organizers of a corporation, in appealing to the investing public for funds, want only capital contributions and not interference with management. To ensure the continued control by the organizers, various plans may be followed. The use of bonds or preferred stock would usually produce the desired results. However, control should seldom be the prime factor in framing the financial plan. Either concentration of voting stock—as in the English use of management shares—or wide distribution thereof will ensure continued control as desired.

Some corporation managements take great pains to see that control is highly concentrated by means of setting up a financial plan that offers no opportunity to outsiders to take control away from those who originally held it. A few examples will illustrate the means employed to reach their goals of control concentration. The holders of the three management shares of the Maple Leaf Milling Co., Ltd., a Canadian corporation, have the right to elect six of the nine directors of the company. Two of these management shares were held by the trustees for the bondholders, and the other was held

<sup>1</sup> Epstein, R. C., "Industrial Profits in the United States," National Bureau of Economic Research, New York, 1934, pp. 39-48.

<sup>2</sup> Paton, W. A., "Corporate Profits," National Bureau of Economic Research, New York, 1935, p. 3.

by the bank creditors. Management stock of the Chas. E. Hires Co. has sole voting rights to elect directors for the first 40 years of the company's existence as long as dividends are not in arrears on Class A cumulative common stock. The management stock is all owned by the Hires family. It may not be transferred on the books of the company but is convertible into Class B common stock. At the time Ayer and Son, Inc., was converted from a partnership to a corporation, each partner agreed that, at the death of one member of the former partnership, the other former partners should have the option to buy enough stock to control the corporation.

The 100 management shares of Canadian Insurance Shares, Ltd., are entitled to elect a majority of the board of directors. All management shares are held in a voting trust subject to an agreement to elect as directors only shareholders who are Canadian citizens or those who have been bona fide residents of Canada for 10 years. The management stock of the United Bond and Share, Ltd. (a Canadian corporation), has sole right to vote for directors as long as the net worth of each issued common share exceeds \$12.50. In event of a drop below \$12.50, the common stock acquires the right to elect directors. On all other questions, management and common stock vote one vote per share. Management stock is not entitled to participate in the profits of the company. When the net worth of each issued common share equals \$34, the management stock will be converted into common stock, share for share.

The above illustrations are admittedly unusual. They were selected to demonstrate how control can be kept within a few hands. A judicious use of bonds and nonvoting preferred stocks, coupled with a wide distribution of common stock, may be equally effective for all practical purposes. This question of control should be given careful consideration but should not outweigh more important principles governing the character of the financial plan.

**Estimating Earnings.**—The importance of earnings in determining the form of the financial plan cannot be too greatly emphasized. We must keep in mind that it is the future earnings of the corporation in which we are chiefly interested. Present or past earnings might justify the financial plan now in use, and still the corporation might fail in the relatively near future because of changed conditions. Since future earnings loom so large in the formulation of the financial plan, means must be found for estimating them. Various tests may be employed, either singly or as checks against each other. The most common are as follows:

1. *Invested Capital.*—Ordinarily, there would appear to be some relationship between earnings and the amount of capital invested. However, capital is only one of the variables whose combination controls the destinies of the corporation. The other important variables are management, labor, resources, and governmental relationships. Perhaps in small businesses,



conducted by men of average ability, under highly competitive conditions, and producing staple commodities sold under conditions that do not identify the producer, the amount of capital invested may be a fair index of the amount of earnings to be anticipated. In larger business units, operated under conditions other than those herein stated, the amount of invested capital should not be taken too seriously as an index of probable earnings.

2. *Earnings of Other Businesses.*—Comparison with earnings of other corporations engaged in the same business, in the same or similar markets, and operating under similar conditions, should be an aid to the estimation of future earnings. To the extent that more efficient management, a superior location, a trained and loyal labor force, or other determining factor gives one of the corporations an advantage, results of comparisons must be discounted.

Comparisons are sometimes made with earnings of unrelated enterprises. These are not only worthless but misleading, because the enterprises selected for comparison always serve the purpose for which they are selected.

3. *Dead Reckoning.*—To the extent that probable demand, at known prices, and probable expenses, can be predetermined, profits may be derived as the difference between these two items. This process is called "dead reckoning." Where advance orders are received and where all costs can be properly anticipated, dead reckoning has its uses. Its promise is usually greater than its performance, however. Results seldom measure up to expectations. War "widowhood," forced upon war "brides," gave headaches and sleepless nights to many a corporation management that had hoped for large predetermined profits from governmental orders. Their dead reckoning failed to reckon with the extent to which costs could increase under pressure against time, particularly if an industry organized to produce one line of products attempted, overnight, to shift to a new and unfamiliar line.

4. *Past Earnings.*—Many promotions start with a going concern. Expansions, mergers, and consolidations are of this type. Here, past earnings should be available as an index to future profits. They are definite in amount and ready at hand for whatever use may be made of them. Used with discretion, they constitute perhaps the best material available for the purpose to be served. Unfortunately, discretion often plays little part in their use. Instead, they become merely the solid foundation for an imaginative superstructure. The old saying that every institution is but the lengthened shadow of a man, applies with equal force to most business enterprises, particularly in their formative stages. The names of Rockefeller, Carnegie, and Ford are indelibly linked with the business enterprises they organized. Although Smith, Jones, and Brown are not so well known, their contributions to their own business enterprises have been of a similar character. If all estimates of future earnings were subjected to the test of past

accomplishments of the proposed management, many corporations would have greater difficulty in attracting financial support for their ventures.

**Time Factor in Estimates.**—The outstanding characteristic of American business is its dynamic nature. What was popular yesterday may be discarded today. Teachings of ancient history may not be applicable in the solution of the problems of today. Comparisons must be adjusted to changed conditions. Averages may be misleading where trends are desired. Selected periods for purpose of comparison are always open to suspicion.

New conditions confront the business world without warning. Business leaders are properly credited with much of our economic and industrial progress. Business judgment appears to be more effective in developing ideas than in creating them. In great crises, business leaders share with the crowd in their impotency. Even their courage fails them when they need it most. With fundamental changes wrought by time, old rules no longer apply. Comparison with the past alone is an insufficient guide to a new and different future.

**Formula-mindedness.**—Insistence upon the application of all the tests proposed in this chapter before a financial plan for a corporation is formulated has its shortcomings. Necessarily the subjects so far discussed are somewhat nebulous in character. It is difficult to secure the desired information and even more difficult to translate it into mathematical terms. Yet inexperience looks for exactness where it does not exist. And indolence is inclined to seek the short cut to a solution of a difficult problem. It is so much easier to assume similarities between two sets of circumstances than it is to test their likenesses that we are inclined to look for a formula by which we can gauge the new conditions presented to us. The formulas applied to determine what securities may be legally purchased by savings banks is a case in point. Their application gives no assurance of either excluding all weak securities or including all sound investments. Even where averages indicate a pretty satisfactory answer to the problem at hand, individual situations may fall considerably short of the average. In like manner, the rules commonly applied in the establishment of financial plans for new enterprises afford evidence of the application of formula-mindedness. Measured by the sad test of experience, the formulas frequently fail to produce desired results in individual cases.

**Industrial Classification.**—In applying suggestions concerning necessary features of financial plans to various specific cases, it is necessary first to group business enterprises into broad classes. Such classification at once suggests more or less specific patterns for the building of financial plans of new enterprises. Such suggestions should be used as guides, subject to careful checking and, if need be, serious modification in specific instances. Industrial patterns for financial plans are useful, provided they are not followed too slavishly. The exceptions to general rules are sufficiently

numerous to cause careful study of each specific case to determine whether it is covered by the general rule or whether it is one of the many exceptions.

In the study of specific financial plans, there has been a distinct tendency to give major, if not sole, attention to those industries which employ the greatest proportion of fixed capital. This emphasis has a logical as well as a historical explanation. In the beginning of our industrial development, fixed capital was supplied from the proceeds of the sale of stocks and bonds; circulating or working capital that the corporation required from outside sources was obtained from trade creditors and from commercial banks. Also in the field of merchandising, for example, it has been customary until quite recently to organize business enterprises in forms other than corporations. In numbers at least, proprietorships and partnerships still bulk large in the merchandising fields. In the illustrations that follow, brief attention will be given to various fields of business operation.

**Public Utilities.**—Within their respective market areas, public utilities enjoy certain advantages not common to other classes of business enterprise. In the first place, they are usually granted legal monopolies that free them from most competitive practices. Such competition as they must face is that provided by the producers and distributors of substitute goods and services. Producers of electricity compete with distributors of gas; oil and coal compete with gas for heating and for industrial uses; private automobiles compete with streetcars; etc. But few of the utility corporations are required to compete with corporations of the same kind in the same market. Relatively speaking, operating public utilities enjoy a steadier flow of net income than other types of business enterprises. While a steel corporation may be called prince or pauper, depending upon whether it is in a period of prosperity or a depression, the consumption of the services provided by a public utility never increase greatly in prosperity nor decrease greatly in depressions, in comparison with many other industries. As a consequence, its net earnings are relatively stable.

This does not mean that public utilities cannot fail and jeopardize the holdings of those who own their securities. The effects of the competition of substitutes may be so great that the utilities cannot survive. Witness the complete disappearance of the interurban railways and the sharp decline in the earnings of many urban transportation corporations as the result of competition of trucks and busses. Also, even where competition is not present, a public utility corporation may have misjudged its market and provided facilities that cannot earn their way. If the potential users of the service cannot or will not buy it, or if the locality served is on the decline, or if costs increase much more rapidly than rates for services, the utility may be a financial failure.

**Financial Plan.**—Within these limitations, the relatively stable earnings of operating public utility corporations usually permit the use of bonds and

preferred stock in their financial plans, as well as common stock. Bankers who participate in the flotation of utility bonds usually insist upon a maintenance of a two-for-one ratio at the time of issue; *i.e.*, that the interest on the bonds plus all other fixed charges shall not exceed one-half of the expected annual net earnings. Since the rates of interest on utility bonds are not peculiar to the industry, the amount of bonds that can be issued under the two-for-one formula will vary not only with the earnings, but with changing levels of interest rates. The kinds of bonds used depend, in part, upon the nature of the assets and, in part, upon the traditions of that particular part of the industry. For example, electric-light companies are more likely to use mortgage bonds than are telephone companies.

Preferred stocks of public utilities are usually limited in amount, at the time of their issuance, in such manner that their dividend requirements will absorb not more than one-half of the anticipated earnings left after providing for fixed charges. Even with this assumed protection, they cannot be rated higher than "speculative investments," in spite of the sound reputation that promoters and bankers attempt to give them. The estimated earnings are always liberal in amount. Any failure to reach the estimate bears heaviest upon the preferred stockholder who expects an annual dividend on his shares. Not only must fixed charges be met first, but any appreciable decline in net earnings or even the presence of a general business depression which does not result in a definite decline in net earnings for the utility tends to make the management dividend cautious.

The amount of common stock issued by public utility corporations is usually governed by the demands of promoters, bankers, and underwriters on the one hand, and by the degree of supervision exercised by public utility commissions on the other. Where bonds and preferred stock are used, the common stock frequently represents the profits of the promotion process. With respect to new corporate setups resulting from the operation of the Public Utility Holding Company Act of 1935, the Securities and Exchange Commission may have considerable to say about new financial plans.

In the foregoing discussion, the emphasis has been placed upon the financial plan with which the corporation began operations. Since public utility bonds and preferred stocks are commonly callable and convertible, it is not unusual for original plans to undergo considerable modification in subsequent years. No attempt is made at this point to consider changes in financial plans that result from failure and from resulting reorganization. These will be considered in later chapters. Also the public utility corporations referred to in the foregoing discussion are the operating companies. Financial plans of holding companies will be discussed in a later chapter.

**Railroad Corporations.**—The financial plan of railroads can be discussed only as a matter of history; since no new railroad promotions have been

undertaken in many years. Early railroad promotions combined the piety of the ministers of the gospel, who were induced to preach sermons on the social and moral values of railroad transportation; the persistence of doorbell ringing stock salesmen who tried to sell railroad stock to every householder; the open-handedness of the politicians who passed out public lands, money, and credit to ensure the construction of the new means of transportation; the vision of empire builders who saw the railroad as the agency for colonizing and developing vast stretches of unoccupied territory; and the unscrupulousness of promoters and owners of construction companies who took full advantage of the universal desire for railroads and more railroads. In the history of American railroad finance, one can find almost all the evidence he needs to prove that every kind of chicanery in the decalogue was practiced in their construction. Even after admitting all the crimes that have been charged to railroad promoters and builders, the cost of opening up a vast continent for industrial expansion was exceedingly low. One might wish that greater honesty and efficiency had prevailed in early railroad financing. Nevertheless, the amount actually paid was low in comparison to the benefits achieved.

In the financial plans of modern railroads, there is little to remind the student of the puny financial plans that characterized the origin of their predecessors. Up to the decade of the 1870's, the pattern of bonds which has since become so common was not yet thought of. Financial plans were relatively simple during the 40 years from 1830 to 1870. First common stock predominated; then preferred stock was used, together with short-term bonds that were intended to be redeemed. Many even had sinking-fund provisions. The rapid extension of the railroad net in the decade of the 1870's, with its consequent encouragement to equally rapid growth of national wealth and population, convinced financiers and the investing public of the permanency of the need for railroad service. Fundamental changes in financial attitudes followed. Permanent debt was no longer feared. Fifty-year bonds made their appearance for the first time, to be followed by 100-year and even longer maturities. Sinking funds and other plans for debt retirement gave way to an expectation of indefinite refunding operations.

Even the amount of the debt became more or less a matter of indifference. With a rapidly growing country, demanding more and more of its railroads, would not its people soon justify with their increased traffic any fixed charges that the railroads might incur? Even periods of depression which left in their wake great sections of the railroad net in receiverships were looked upon only as temporary detours on the high road to eternal prosperity. As a consequence, when a large fraction of the total railroad mileage went into the hands of receivers in the 1890's, because the railroad corporations could not meet their fixed charges, they emerged a few years later with financial plans

that temporarily forgave them a part of their fixed charges, at the expense of ultimate charges even higher than those that caused their financial distress.

**Financial Plan.**—As a consequence of this psychology, the common pattern of American railroad financial plans finds a heavy overload of bonds of many grades of priority. In general, they have mortgage bonds at the base. Superimposed upon them are great quantities of guaranteed stocks, resulting from leases and combinations of one kind and another. These become, for the lessee corporations, the same as debenture bonds. Income bonds have been used frequently in reorganizations of railroads. Mortgage bondholders are coerced into taking, in exchange for a fixed interest bond, one whose return is dependent upon income. The mortgage status is usually retained, so far as the security of the principal of the bond is concerned. Railroad equipment is almost universally financed by the use of equipment trust certificates. The combination of these various classes of fixed-charge obligations has created a burden that even earnings of good years have difficulty in meeting.

With the progressive decline in the use of railroad facilities during the two decades preceding the Second World War, due to the increasing competition of trucks, busses, privately owned automobiles, and airplanes, it is little wonder that new legislation was required in anticipation of the flood of railroad receiverships that was threatened in the decade of the 1930's. Since most railroad bonds are not callable, even strong roads have not been able to better their financial plans by refunding during periods of low money cost. Railroad expansion has almost always been accomplished through the sale of more bonds. Three reasons account for this. (1) A railroad cannot expand in a small way. If it needs a 10 per cent increase in the capacity of a specific line, it may need to double-track that part of its property, thereby increasing its investment, not 10 per cent but 100 per cent or more. (2) Because of the slow turnover of its capital it cannot hope to expand satisfactorily from earnings. (3) Railroad credit has seldom encouraged the sale of stock for expansion purposes.

Most of the preferred stocks issued by railroad corporations are the result of reorganizations. Bondholders have been forced to take preferred stock in place of bonds on which the corporation could not pay a fixed interest charge. Nearly all railroad preferred stocks carry a low dividend rate; they are entitled only to noncumulative dividends; but they have the right to vote. Common stocks are also frequently the children of reorganizations. As such, they have been given to holders of the less well-protected securities of corporations that were forced to revamp their financial plans. Almost always such common stocks represent no realized earning power. They are merely certificates of hope. Their prices usually reflect the low esteem in which they are held by the investing public.

The financial plans of railroad corporations need to give but little attention to the subject of current assets. Approximately 95 per cent of the railroad assets are fixed, leaving only 5 per cent current. Much railroad revenue is prepaid or is collected monthly. This fact, in addition to the small proportion of current assets, makes the question of circulating or working capital relatively unimportant. Even public utilities other than railroads are not much concerned with provisions for current assets. Although their proportions of current to total assets are somewhat higher than for railroads, they are still very low in comparison with other types of business enterprise.

**Manufacturing Corporations.**—Because of the wide variations in the capital needs of manufacturing corporations, generalizations about their financial plans mean less than corresponding conclusions about railroads and public utilities. A manufacturer may or may not own his plant, for example. Some do not even own their equipment. For most manufacturers the proportion of current assets to fixed is quite high, frequently approximating equality or even higher. In many instances, manufacturing corporations have a considerable capital tied up in credits to those who buy their goods. Since many manufacturing corporations are organized to exploit a new product or a new process, there are always many uncertainties concerning its initial capital needs. The scale of operations is frequently modest at the start, suggesting a tentative financial plan that may be modified as the business develops.

The type of financing to be employed by a specific manufacturing corporation depends upon several variables. Frequently much of its capital, including patents, and perhaps even much of its fixed assets are acquired by exchange of stock for them. In such cases, relatively large amounts of cash may be required from outside sources to provide the necessary working capital. Even where all capital is to be obtained from others than the promotion group, the need for a relatively large amount of cash colors the type of financial plan used. Another variable to be taken into account is the specialized character of the capital used by manufacturing concerns. Failure of an enterprise may leave little in the way of salvage value.

**Financial Plan.**—From what has been just said, it is obvious that bonds have little place in the financial plan of a new manufacturing corporation. The speculative character of such enterprises does not recommend that conservative investors who buy bonds should participate in their initial financing. Where there are distinct classes of stockholders to be served, it is customary to use preferred and common stock. The contributors of the capital, especially those who supply cash, frequently insist upon the preferential rating that preferred stock is supposed to supply. In addition, they may insist upon a bonus of common stock. Promoters, bankers, and others who contribute services or intangible capital other than cash, may have to

be content with common stock. Where there are no sharp differences among the group concerned with the organization of the corporation, common stock is usually given to all classes of participants. Again, however, the element of control may recommend the use of both preferred and common stock, even though there are no sharp differences in the character of the contributions. Then, too, the use of two classes of stock instead of one broadens the market for its sale.

Subsequent changes in the financial plan are governed by new variables. If the corporation is successful, its margin of profit may be large enough to permit future expansion from earnings without the sale of additional securities. New stock may be issued in the form of dividends to satisfy holders who clamor for large distributions in cash or to reduce earned surpluses. In such cases, however, no new outside capital is sought or needed. Where expansion takes place at a more rapid rate than earnings can supply, new securities are sold. First common stock is expected to be used for this purpose. If for any reason the market will not absorb common stock under favorable conditions, either bonds or preferred stock may be used. The bonds may be either mortgage or debenture in form, depending in large measure upon the demands of those who buy them. Where either bonds or preferred stock are used, they are usually callable and convertible. The issuing corporation thinks in terms of future redemption or retirement by conversion into common stock in order to restore the simplicity of its financial plan. In contrast to railroad and public utility corporations, manufacturing-corporation managements usually think at least in terms of getting out of debt when earnings and money markets permit them to do so. Their acceptance of debt obligations is thought of in temporary terms.

**Merchandising Corporations.**—The financing of most merchandising enterprises is complex, although it may appear to be simple. In contrast with a railroad or even a manufacturing concern, a merchandising enterprise uses relatively little fixed capital. Most of its investment is in the form of a stock of goods whose turnover is expected to be relatively rapid. The financing of its stock of goods may be through the use of trade credit, bank loans, or both. Some merchants rent rather than own their store building. They rent, even their permanent fixtures may be a part of the real estate. Or, if the lease is for a considerable number of years, the modifications in the building and even the construction of a new building may be the obligation of the lessee. Whether the merchant owns the building or has only a long term lease on it, his financing of it is in the nature of real estate finance. Some merchandise concerns, including many of the retail chain-store corporations, prefer not to make their capital out of the ownership of real estate and avoid its investment, <sup>in fixed capital</sup> in favor of leasing store locations.

Many merchant <sup>bankers</sup> are initially engaged in the banking



business, to the extent that they are expected to extend credit to their customers. Indeed many of them find the opening of charge accounts a source of a greater volume of business, since it is so much easier for the purchaser to say "charge it" than it is for him to pay cash at the time of purchase. The financing of stock in the hands of customers as well as on the shelves requires a larger investment than if the business were conducted on a cash and carry system. Then too, the personal nature of the merchandising business affects its financing. The merchandiser seldom changes the form of the products with which he deals. He merely performs a personal service in making them available to his buyers. The highly competitive character of most merchandising operations also emphasizes the personal side of the business. As a consequence, the business is most likely to start on a scale of operations that may almost be characterized as a one-man business. Outside financing, other than that extended by trade creditors and banks, is hardly to be expected.

**Financial Plan.**—The foregoing analysis suggests that merchandising corporations frequently finance their real estate or their leasehold as a separate operation, using real estate mortgages, land trust certificates, and leasehold bonds. Other original capital must be contributed by the manager and his close friends. As the business grows and attracts public attention, the growth may be financed in part by earnings and in part by the sale of stock. Other than in the financing of real estate, bonds are seldom used. Common stock is more often used than preferred. The latter is sometimes used to tap sources of capital that will not respond to an opportunity to buy common stock. Where more conservative investors are appealed to through the use of preferred stock, it is likely to include protective provisions that make it akin to a bond issue.

**Real Estate Corporations.**—The financing of so-called "investment real estate" may be based upon any one of several types of business organization. The sole property of a corporation may be a building used by a miscellaneous collection of tenants. A business corporation may organize a separate corporation to hold and finance its building. A business enterprise, without such separate corporation, may nevertheless finance its building separately. In any event, there are usually only two items of capital to be financed: the land and the building. A third is sometimes added, in the form of changes that are required in the building to meet the needs of the tenants. More often than not, these are considered as expense items instead of additions to the capital. Except when one building is replaced by a new one, there is not usually much chance for expansion. On the other hand, there is the ever-present problem of depreciation and obsolescence. Although these are not ordinarily given sufficient recognition and are certainly not adequately accounted for in the financial records, their presence frequently is felt in their effects upon the standing of the real estate other than

of this chapter to suggest methods of financing every conceivable type of business. Rather, typical samples only have been given. With respect to holding companies and the financing of other kinds of combination, additional information will be included in later chapters.

### QUESTIONS AND SUGGESTIONS

1. What is the meaning of the financial plan of a corporation? Upon what fundamental principles should it be based?
2. How important are security market conditions in formulating a financial plan? Explain.
3. What is the significance of anticipated earnings in formulating a financial plan?
4. What conclusions can you draw from the table showing the past earnings experience of various corporations?
5. How can control be concentrated?
6. How can earnings be estimated? To what kind of situation could dead reckoning apply?
7. How important is the human factor in considering financial plans?
8. What is the significance of the time factor in earnings estimates? What is meant by formula-mindedness? How does it apply in estimating earnings?
9. Why is it necessary to group corporations into classes in studying their financial plans?
10. What economic conditions are peculiar to public utilities? How do they influence the kinds of financial plans used by utilities?
11. What part do the traditions of the industry play in the kind of plans used? Give examples.
12. What determines the amount of common stock issued by public utility corporations?
13. What changes in financial plans have railroads experienced?
14. Were the irregularities in the financing of early American railroads all negative in their results? Explain.
15. When did bonds first assume importance in railroad financial plans?
16. What has happened to the financial plans of railroads during recent years?
17. What is the origin of most railroad preferred stock?
18. Characterize the financial plans of manufacturing corporations.
19. How are merchandising enterprises financed?
20. How are real estate corporations financed?

### SUPPLEMENTARY READING

- BURTCHETT, F. F.: "Corporation Finance" (New York: John Wiley & Sons, 1934), Chap. II.
- DOWRIE, G. W., and D. R. FULLER: "Investments" (New York: John Wiley & Sons, Inc., 1941), Chap. III.
- FIELD, K.: "Corporation Finance" (New York: The Ronald Press Company, 1938), Chap. XIV.
- GERSTENBERG, C. W.: "Financial Organization and Management of Business" (New York: Prentice-Hall, Inc., 1939), Chap. X.
- HUSBAND, W. H., and J. C. DOCKERY: "Modern Corporation Finance" (Chicago: Richard D. Irwin, Inc., 1942), Chap. XVIII.
- LINCOLN, E. E.: "Applied Business Finance" (New York: McGraw-Hill Book Company, Inc., 1941), Chaps. VII-IX.

TAYLOR, W. B.: "Financial Policies of Business Enterprise" (New York: D. Appleton-Century Company, Inc., 1942), Chap. XIII.

**SUBJECTS FOR INVESTIGATION**

1. Select from any recent manual an industrial corporation, a railroad, a public utility, a real estate corporation, and a merchandising corporation. Compare their financial plans, and account for any differences that you find.
2. Compare the above plans with those of the same corporations for the year 1935, and account for any differences.
3. Point out and justify any particular weaknesses that you find in answer to either of the above questions.

## CHAPTER XIX

### CAPITAL AND CAPITALIZATION

**Scope of Chapter.**—In the preceding chapter, the financial plan was more or less idealized, with the emphasis on the planning side. This chapter deals primarily with the terms “capital” and “capitalization” in such a manner as to show what happens when enterprises are financed without giving adequate attention to advance planning. On the basis of experience, many financial plans would rate very low indeed. While no one has yet devised a scheme for classifying such plans, elements thereof are replete with failures and the necessity for readjustment. Every bond extension, adjustment of interest charges, forced refunding, and any other change in the original contract made necessary by the inability of the issuing corporation to meet its obligations; every similar change in preferred stock issues; and every sacrifice made by common stockholders may be scrutinized for evidence of a faulty financial plan. Occasionally, other causes are present. Rarely would they overrule the accusation of faulty financial plan. The test of the financial plan is its failure or success. When one plan fails, we try another. The second may not be a great improvement over the first. Managements and owners are given an opportunity to review their plans and to improve them if they fail. Conflicting interests often prevent the adoption of adequate plans as second guesses. This subject is treated later in this volume.

✓ **Confusion of Terms.**—The terms “capital” and “capitalization” are difficult to define because they are used in so many different ways by different people. Also they are sometimes used as if they were more or less synonymous terms. Even state statutes have added to the confusion. Before proceeding to a discussion of the common financial practices involving the use of these two terms, it will be necessary to review some of the different concepts that employ them.

✓ **Economist's Concept of Capital.**—The economist has usually maintained a definition of capital that is simple, logical, and descriptive of conditions common in Adam Smith's day, *viz.*, that capital is accumulated wealth dedicated to the production of more wealth. Since the corporation is set up specifically for the purpose of making a profit, presumably by the production of additional wealth, it seems logical that the economist should have defined its chief tool—capital. By the time the accountant, the businessman, and the lawyer have each taken turns at interpreting the items on the corporate balance sheet, this concept of capital loses much of its simplicity.

As a matter of fact, having defined capital in the foregoing terms, economists are not always consistent in the use of their own definition. For example, certainly from the standpoint of its owner, much land would seem to be wealth accumulated for the purpose of creating more wealth. Yet economists are inclined to exclude land from their concept of capital. Likewise, a corporation management looks upon its accounts receivable and even its intercorporate holdings of the stocks or bonds of other corporations as capital. Economists would probably exclude them as mere claims to goods which are themselves the only true capital. In the same manner, the economist would exclude intangible items like good will on the ground that they are not wealth used to produce more wealth.

**Accountant's Concept of Capital.**—Accountancy deals only with concepts subject to measurement in terms of money value. The very nature of such measurement is accounting for—i.e., attributing value to—the things with which it deals. The accountant's definitions of a steam railroad would necessarily be similar to his definition of a grocery store or an airplane factory. Each consists, on the one hand, of an aggregate of possessions, capable of being described in monetary values and, on the other hand, of claims against such possessions, likewise to be described in monetary terms. In the aggregate, the possessions are expected to balance the claims.

Conservative accountants take no responsibility for original valuations. They make no claim to being evaluators. Consequently, they accept the money labels given by others to possessions and claims, provided always that they offset each other. If they do not, adjustments must be made until they do. The original balance sheet of a corporation frequently overstates the value of ~~value of~~ **capital**. Thereafter, accountants are careful to avoid giving a value to **Capital** that is not purchased with a claim. Since write-ups are properly ~~properly~~ **Capital** kinds by accountants, accretions to corporate capital that do not result from ~~corresponding~~ outlay, whether because of the development of valuable good will by a competent management or because of the fortunate location of a plant in a growing city, are not recognized by the accountant. The net result is that the accountant may not arrive at the same definition of capital as the economist.

According to the accountant, every capital item carried on the assets side of the balance sheet at a value would be capital. Property no longer used but not written off is capital to him because it still has a value label attached to it. If good will is carried at a value, it is capital. If it has been written off, it is no longer capital, even though it remains just as potent as ever in attracting new business to the corporation. Unlike the economist who places prime emphasis upon the use of physical property, the accountant uses as his major test the presence of a value label which presumably has been placed upon property—tangible and intangible, used and useful physical

assets, and mere personal claims of all sorts—by some one in authority with capacity to make final decisions for the corporation.

**Businessman's Concept of Capital.**—The average businessman would probably deny any interest in an attempt to define capital. Yet he makes constant use of the term in a variety of ways, some of which conflict with each other. Among these are the following: (1) He may have in mind the proprietor's original contribution. Even though the corporation grows to control \$1,000,000 of assets, the businessman frequently thinks of its capital as the \$10,000 contributed by its original stockholders. (2) He may consider capital to consist of the material plant, equipment, etc., used by the corporation in its productive operations. At this point, the businessman unconsciously accepts the economist's definition. While instructing the accountant to include various intangibles, the businessman is inclined to exclude them when he thinks in terms of capital. (3) Again he may consider the capital of his corporation only that part of the ownership of physical plant, etc., which is the property of the stockholders, after deducting the claims of creditors. (4) Like others interested in the subject, the businessman distinguishes among the kinds of capital, such as tangible and intangible, when descriptive adjectives qualify the term.

**Lawyer's Concept of Capital.**—In spite of the juristic parentage of the entity concept, lawyers tend to emphasize rights and claims in considering terms like capital. As a consequence, they sometimes speak of capital in terms of liabilities and again in terms of assets. Perhaps in using capital as a liability, the lawyer really means capital stock but says capital. Certainly there is evidence that, in the development of the trust-fund theory of corporate capital, the lawyer was thinking primarily of the assets side of the balance sheet. Those who still give any credence to the lawyer's theory of protecting creditors expect to find somewhere in his capitalization portfolio a capital fund that cannot be impaired ~~with the same~~ <sup>by the same</sup> ~~different~~ <sup>different</sup> ways. In the face of the laws ~~as if they were more~~ <sup>as if they were more</sup> ~~a no-capital~~ <sup>a no-capital</sup>, it is to be hoped that ~~late statutes have added~~ <sup>late statutes have added</sup> ~~theory have had no part~~ <sup>theory have had no part</sup> in the ~~drafting~~ <sup>drafting</sup> of such ~~regulation~~ <sup>regulation</sup>.

**Common Concept of Capital.**—Businessmen have found it to their advantage to ~~conceive~~ <sup>conceive</sup> the various concepts of capital in ways that ~~definitely~~ <sup>definitely</sup> identify none with the capital of any specific corporation. In one case one concept seems to predominate, while in another situation another concept of capital may play a larger part. In some instances, corporate practices in ~~accumulated wealth~~ <sup>accumulated wealth</sup> "capital" are ~~concentrated~~ <sup>concentrated</sup> primarily in terms of ~~minimizing~~ <sup>minimizing</sup> ~~the~~ <sup>the</sup> corporation is set to prospect the purchasers of securities may dictate ~~primarily~~ <sup>primarily</sup> by the product of circumstances. Since the use of the corporate ~~economist should~~ <sup>economist should</sup> have ~~prize~~ <sup>prize</sup> invites manipulation of the capital account ~~without~~ <sup>without</sup> ~~it is~~ <sup>it is</sup> necessary to use qualifying terms to identify the ~~particular~~ <sup>particular</sup> interest in the

subject. Even then there may be no way to identify the kind of capital in which the interest lies. A few examples will illustrate these difficulties.

1. Legal capital is that part of invested capital required by law to protect creditors. It is not available for dividend distribution. The common use of the concept of "stated value" has made legal capital a fiction in many states. Suppose that five men owned a business whose assets aggregate \$1,000,000 in actual value. It would be possible to incorporate this business in the state of Ohio and declare their legal capital to be \$500. Other considerations would probably make this inadvisable, but the law would present no obstacles. In any specific corporation, the legal capital may bear no definite relationship to the true value of the assets.

2. Invested capital represents the total contributions of the stockholders. For reasons just stated and others, the balance sheet seldom discloses this amount.

3. Proprietorship capital is the net worth after providing for all prior claims. Assuming that all claims at least are recorded, it should be possible to calculate the net worth *as shown on the books*. Because of common practices of either under- or overvaluation of both assets and liabilities, true net worth is not always calculable.

4. Total capital is variously defined to include only productive assets used and useful in the business, or total assets as shown by the books, etc. Total assets as shown by the books at least are calculable. Under- and overvaluations and undisclosed assets cloud the accuracy of book figures.

Because of the confusion that surrounds the use of the term "capital" in corporation finance, it is essential to use the qualifying adjective that would otherwise be implied. Or, better still, it is probably better to use such terms as net worth or proprietorship capital instead.

**Kinds of Capital.** Nearly all business enterprises find it necessary to utilize two kinds of accounting. Capital is comparatively easily defined to include land, building, and corresponding outlay, with other assets having a relatively permanent existence. At least management accounting is useful for a time longer than the accounting period. The record-keeping account of capital needed varies greatly from one business to another. In a trading corporation business, for example, nearly all the capital would be defined as *fixed capital*. In many merchandising enterprises, on the other hand, only a relatively small amount of the balance capital may be needed.

Used but not written down to define that part of the capital of a corporation attached to it. If goods are sold, we immediately encounter the confusion of being written off, it is not. The confusion arises, in part, from the failure as ever in attracting no terms to be used and, in part, from the fact that the terms are employed to describe different concepts. From the standpoint of a proper understanding of the financial needs of the business, what is

needed is a term that will describe that part of the capital of the business which is not properly classified as fixed capital. It includes the cash needed to keep the business in successful operation, the raw materials and the goods in process of manufacturing into finished products, the inventory of finished products ready for the market, and the credits arising from the sale of previously finished products that have not yet been paid for in cash.

**Terms Used.**—To describe that part of the capital which is not classed as fixed, a variety of terms are used. Among the adjectives commonly employed are "current," "working," "circulating," "liquid," and "quick." The term most commonly used to define this kind of capital is "working capital." But here we immediately encounter the difficulty of using a term that is used to define two different concepts. Sometimes it is intended to include approximately all current assets. As such it is descriptive of the capital of a corporation that is not fixed. Such use disregards the claims against the capital and deals only with the assets side of the balance sheet. But the more common use of the term "working capital" is to consider it as the difference between the book value of the current assets and the current liabilities of the business enterprise. Here the emphasis is shifted from the capital available for use to the banker's point of view of attempting to evaluate the liquidity of the corporation. It might almost be said that the gross working capital concept emphasizes the going concern point of view, while the net working capital idea visualizes the possibilities of liquidation and its consequences.

For example, suppose that corporations *A* and *B*, engaged in the same kind of business and of approximately equal size, each have a total of \$1,000,000 invested in current assets, consisting of cash, raw materials, goods in process, finished products, and credits arising from the sale of the goods formerly finished. So far as the assets side of the balance sheet is concerned, one corporation seems to be in about the same position to serve its customers as the other. In other words, their gross working capital is the same. But suppose that *A*'s current liabilities amount to \$900,000 while *B*'s amount to only \$100,000. Undoubtedly, if *A*'s creditors press it for payment of its debts, it is in a much more vulnerable position than *B*. Consequently, from the standpoint of the possibilities of liquidation, the amount of net working capital assumes importance. It is unfortunate that different words are not used to describe these two different concepts. It would help if the qualifying terms "gross" and "net" were always used to denote the different ideas to be expressed. Since they are not, it is not always possible to determine just which concept is meant when the term working capital is used.

Because of this confusion, it has been proposed by various writers that instead of working capital the term "circulating capital" be substituted to describe the current assets used in the production of goods and services. The term "circulating capital" is not new. It was used by Adam Smith in his



"Wealth of Nations," written nearly two centuries ago. The common use of this term today would have the advantage of differentiating from fixed capital that kind of capital which is expected to change its form or circulate through the stages of the current capital cycle. This cycle starts with cash. A corporation invests its cash in labor and materials. These materials are transformed into finished products which are sold, in many instances, on credit. When these credits are liquidated by payment in cash, the cycle is completed. Instead of circulating or working capital, the term "current capital" has also been proposed. Logically, either current or circulating capital is preferable to working capital to describe that part of capital which is not fixed. Actually, working capital is more commonly used, probably because of the dominance of the banker terminology in financial affairs.

**Kinds of Current Assets.**—The first, and from some points of view, the most important item listed among current assets is cash. This may include not only currency in the corporation's till and credits in bank checking accounts, but readily marketable securities that can be turned into cash on a moment's notice. It is always a comforting feeling to have ample cash on hand. Its presence may determine expansion policies of corporations that might hesitate to undertake certain programs in the absence of a well-filled bank account. On the other hand, no business enterprise ever attains the success it hopes for if it possesses too much idle cash. The amount of cash carried will differ with a number of variables, among which is the stage of the business cycle. As a general rule, few business managements like to keep too much cash on hand during periods of prosperity. Then things become more sought after than cash. Large amounts of cash may pile up because there is no adequate place to put it. In periods of depression, however, cash first becomes a necessity for those whose creditors are pressing for payment. Then in the race to turn everything possible into cash before prices drop still lower, the desire for cash may amount almost to a mania with some managers. To be sure, the desire may not always be translatable into actuality.

It should be noted also that the cash held at any time by a specific corporation may be needed for purposes other than to meet circulating capital needs. For example, it may be used to add to plant capacity or to pay for new equipment. In some cases it is expected that the treasury will be replenished from the sale of the additional units of goods that will be produced with the added facilities. In other cases the cash may be used temporarily, pending the successful disposition of a new stock or bond issue. Or, if the cash so used is considered to be in excess of that needed for circulating capital purposes, it need not be replaced from any source. Then too, the amount of cash on hand at any given time may be determined in part by dividend and interest requirements and in part by the policy of the corporation in retiring its outstanding issues of bonds and preferred stock.

As a selling aid, many corporations find it necessary to accept accounts receivable in payment for their goods and services. Investment in them is just as essential to the life of the corporation as investment in buildings or raw materials. In a very real sense, therefore, accounts receivable are a form of capital. It is evident that a business enterprise may have on its books at any one time too large an investment in such accounts, or the quality of its accounts may be low. These are matters of business policy that require careful management.

Inventories, both of raw materials and of finished products, will vary with the type of business conducted. Manufacturing concerns stock up on raw materials; merchandising establishments fill their shelves with finished products; while public utilities carry only small inventories of any kind. Inventory policies may well become major factors in determining the success or the failure of business enterprises. Some managements buy their materials as they are needed. Others speculate in raw materials or in goods for their shelves to the extent that price fluctuations rather than service to the public become the chief cause of business results. Unlike cash and the book value of accounts receivable, values of inventories may go up or down with surprising rapidity as changes in the stages of the business cycle succeed each other. Depending upon the accounting methods used, these price changes may not be reflected on the books for some time after they occur.

**Amount of Circulating Capital.**—Several variables combine their influence to determine the proportion of circulating capital to fixed. At one extreme the percentage is almost negligible, while at the other the amount of fixed capital is very small in relation to circulating. The major determinants of these proportions are as follows:

1. *Character of the Business.*—As a general rule, railroads and public utilities have but a small proportion of their capital in other than fixed form. Selling a service instead of a commodity, they have little need for large inventories. Operating for the most part on a cash, prepay, or short-term credit basis, accounts receivable are never carried for long periods of time and in the aggregate do not bulk large in their balance sheets. Consequently, they have little need for large amounts of current assets. This does not mean that such enterprises are never pressed for cash. On the contrary, maintenance is frequently starved in periods of depression because there is insufficient cash in sight to finance the needed repairs. But even though the amount of current assets needed is sometimes not available, the proportion of current capital to fixed is never high, seldom exceeding 5 per cent of the total capital.

At the other extreme, merchandising institutions that do not own their real estate may have very little invested in fixed capital. Their stock in trade represents their major investment, outside of their receivables which

may be quite large. They hope to turn their stock frequently, some of it several times each year. Because of the necessity of carrying large inventories of raw materials, as well as a stock of finished products available to customers on short notice, manufacturing corporations are expected to make great use of circulating capital. Some will have proportions as high as or higher than those that characterize the practices of merchandising businesses.

2. *Length of Processing Period or Merchandising Cycle.*—The amount of circulating capital needed is directly proportional to the time consumed in the manufacturing period or the length of the merchandising cycle. In a manufacturing operation, when raw materials must be carried for a considerable time in the processing stage, with progressive increments of labor added before the finished product appears, the producer must maintain a larger investment in circulating capital than if the processing period were shorter. In like manner, the longer the merchandising cycle—cash to inventories to sales to receivables to cash—the greater the need for circulating capital.

3. *Rapidity of Turnover.*—The amount of circulating capital needed is inversely proportional to the rapidity of turnover. The corporation that must carry a large stock that turns slowly must have a larger investment than one whose annual volume is reached by more rapid turnover.

4. *Scale of Operations.*—In very small corporations, high overhead, high buying and selling costs, less efficient technical equipment, and other concomitants of small size usually mean a high proportion of circulating capital per unit of sales. Medium-sized corporations have an advantage over their smaller competitors on each of the points mentioned. Very large corporations, however, frequently suffer from size, for there are so few purveyors of materials, bankers, and other necessary adjuncts to their operations able to serve them. Plans must be made for a longer period in advance; this fact results in a relatively greater investment in circulating capital than for the medium-sized corporation.

5. *Volume and Terms of Purchase and Sale.*—Operators, selling on orders only, tie up much less in circulating capital than do their competitors who take pride in full-line inventories and in being fortified at all times with ample supplies to meet their present and prospective needs. Likewise, "shoestring" operators, who try to buy on longer terms than they use in selling, tie up less in circulating capital than, for example, do corporations that follow a different policy. Indeed, some sellers require unusually large investments in circulating capital because their selling terms are so liberal that they tend to finance the operations of those who buy their products.

6. *Seasonal and Other Variations.*—Corporations, such as those engaged in the canning industry, which concentrate their production within a few weeks of the year, with sales and deliveries or at least collections some months later, require a larger amount of circulating capital than do those

whose operations are so regularized that their outlay for materials, labor, and other expenses is matched by their income from previous sales.

**Budgeting and Circulating Capital.**—The preceding analysis assumes at least reasonable efficiency in the use of available circulating capital. It is recognized that unusually efficient management would require less cash, for example, than one that is unusually inefficient, regardless of the character of the industry, the length of the processing period, etc. The use of financial budgets will facilitate efficiency in the use of available resources. In building such budgets, it is assumed that all the above factors are taken into account. As is pointed out in the discussion of budgets—to be covered in a later chapter—one advantage to be gained from their use is the more efficient use of capital already at hand. Since many business enterprises suffer from too little circulating capital rather than from too much, it is essential that each dollar be made to work as efficiently as possible. The conservation of circulating capital may be effected by the following:

1. Better correlation of production and distribution of products. An increase in the rate of inventory turnover makes possible a larger volume of business with the same investment in circulating capital, provided that sales can be increased enough to absorb the additional amount.

2. Improvements in selecting credit risks and in speeding up collections decrease the demand for circulating capital from other sources.

3. Purchases may be standardized in such a manner as to make the use of existing circulating capital more effective.

4. Producing, selling, and administrative expenses may be reduced, thus relieving the pressure on circulating capital.

5. Sometimes discarded assets may be redeemed and salvaged.

6. Adequate maintenance policies can be employed to conserve circulating capital and thereby avoid costly delays that are due to breakdowns.

**Purposes.**—In defining the purposes of circulating capital, one must visualize the business enterprise under different sets of circumstances: (1) as a new concern, (2) as a growing enterprise, and (3) under the varying conditions that surround and determine the fortunes of the business enterprise after it has attained its majority. Every new business passes through an experimental period characterized by considerable fumbling before it is properly headed in the right direction. A part of the expenditures during such period should be classed with fixed capital investment, and a part constitutes the circulating capital necessary to get it started. The latter constitutes the primer necessary to start the enterprise. Because of the experimental nature of the business, a part of the original circulating capital may be wasted. It may be said that this is a part of the circulating capital that fails to circulate. Its dissipation leaves as a reminder an account on the balance sheet frequently designated organization expense. It cannot be avoided. Neither can it be turned again into liquid form. For that

reason, it is essential that it be obtained from long-term investment sources rather than from short-term borrowings.

As a general rule, optimistic promoters are inclined to give too much attention, proportionately, to fixed capital needs and too little to the demands of circulating capital. Consequently, the enterprise is shortly embarrassed for lack of funds before it has had a fair opportunity to demonstrate its reasonable earning capacity. Optimism feeds upon dreams of immediate profits instead of facing the nightmare of probable losses for a time after the business is launched.

In addition to the amount of capital that is invested in going-concern value, every corporation must have an initial investment in circulating capital that does not fail to circulate. The amount varies with the type of the enterprise and with the ambition of the promoters. Naturally, a small business will require a lesser amount of circulating capital than a larger business in the same industry. The amount needed will grow as the enterprise expands until, imperceptibly, the initial investment assumes the proportions usually designated as regular or normal circulating capital. It consists of the cash, inventories, receivables, and prepaid expenses necessary to the regular conduct of the business. Any going concern will always have some investment in these forms. In addition, it will have larger amounts varying from time to time for various reasons. Some businesses have seasonal demands for circulating capital that may be several times their minimum investment in this form.

Cyclical fluctuations in business volume cause wide variations in demand for circulating capital. Both extremes of the cycle are likely to create unusual demands. When businesses are prosperous, their optimistic managements do not hesitate to invest large amounts in inventories and receivables. Cash sells at a discount during optimistic periods, and so this form may decline in amount. Commitments are made without fear of the future, and businesses tend to finance each other. During depressions, inventories and receivables tend to remain large, for the former cannot be disposed of readily and the latter cannot be easily liquidated. Gradually, both take the form of cash because our mania for liquidity urges an abandonment of our original purposes as long as the haunting fear of the unknown future grips us. Prolonged depressions result in large investments to meet operating losses while overhead is being maintained in the hope of better times ahead.

In a sense, cyclical changes create emergency demands for circulating capital. Perhaps it would be more accurate to classify the business cycle as a succession of emergencies, each bringing its own problems. In addition, many businesses face other emergencies that affect their circulating-capital requirements. These include the cessation of operations due to fires, floods, strikes, and other unwelcome and unexpected happenings. Likewise, emer-

gencies of quite a different sort, like unusual demands for products in time of war, create circulating capital problems.

**Kinds of Investment.**—By definition, circulating capital is expected to change its form frequently. It is in a continuous stream, flowing through the steps in the production cycle—cash, inventories, stock, sales, receivables, to cash again. Meantime while this kind of capital is constantly changing its character, at least a part of the investment therein may be permanent. In other words, most corporations always maintain a minimum of investment in circulating capital. In addition there will be, for most business enterprises, various reasons for temporary increases in the amount of investment in circulating capital. In meeting these capital needs, it is possible for corporations to follow any one of three policies:

1. Some corporations sell stocks and bonds and use their undistributed earnings to pay for fixed capital and depend upon banks, merchandise creditors, etc., to supply them with circulating capital.

2. Others use the proceeds of the sale of securities and their capitalized surplus to supply them with both fixed and circulating capital. Such corporations are not ordinarily borrowers from banks. They may be lenders instead—in the form of deposits, which may be idle a good share of the time.

3. Still others recognize that their demands for circulating capital vary, sometimes with the seasons and sometimes for other reasons. As a matter of fact, the demands for fixed capital vary also. Occasionally, a corporation is able to own a supply of fixed capital to meet its minimum needs and to hire that owned by others when the rush season arrives. This is a much more common practice with circulating capital. When a corporation recognizes this latter situation, it may meet it in the following manner: It may have permanent investment, represented among its equities by stocks, bonds, and capitalized surplus, equivalent to the amount of its minimum circulating capital needs. Seasonal and emergency needs are met by variable investment, evidenced by loans from banks or other financial institutions or by accounts owed to trade creditors.

The first of these three plans contains evident dangers. Too great dependence upon banks and other financial institutions puts the corporation at a decided disadvantage. Loans may fall due or be called at embarrassing times. At such times, bankers become silk merchants, and silk merchants become agents of bankers. Dependence upon trade credit is no more reassuring. If those who supply raw material are able to carry their debtors at all, they do so on terms favorable to the creditors. These may become very exacting at times when the debtor cannot avoid them because he has no other source of credit available.

The second plan may result in a redundancy of capital except at the peak periods of the year and of the business cycle. Ample circulating capital is desirable. Excess capital of any kind results in loss of return upon it while

it is idle, in speculative ventures within and outside the business, and in wasteful expansion.

The third plan recommends itself most highly. Contractions can be effected by payment of current obligations. This strengthens the credit standing of the corporation and puts it in position to expand its circulating capital as and when needed. The corporation at all times is in possession of ample but not redundant circulating capital. Morale is maintained at a high level, and the corporation is always in a position to take advantage of favorable market developments.

**Surplus Funds.**—In contrast with those corporations which depend upon outside sources for circulating capital, there are others which temporarily or more or less permanently are in possession of what may be termed "surplus funds." If the funds are temporarily held by the corporation, their possession may constitute serious problems for the corporation. To let them lie idle is uneconomical. To distribute them in the form of dividends may be inadvisable since they may be needed at an early date for a specific purpose. Even where it is expected that there will not be an immediate need for surplus funds, their possession may complicate the financial plans of corporations. In the paragraphs that follow, brief attention is given to the nature of the problems created by surplus funds.

**Sources of Surplus Funds.**—There are many sources of surplus funds, some of which suggest the ultimate uses to which the funds are to be devoted. Among the most common are the following:

1. Current earnings, withheld from distribution to stockholders. Perhaps it is intended to invest these earnings in the business, though not immediately. Possibly future construction programs are already planned but are not ready for execution; or possibly only vague plans for the use of the funds have been formulated or discussed, but no definite time or purpose has been agreed upon. The common use of stock dividends complicates the problems of surplus funds by retaining in the business what would otherwise be distributed in cash. The stock dividend may satisfy the stockholder. At any rate, it leaves the cash with the corporation. Undoubtedly such practices, where generally adopted, have profound effects upon the balance of spending and saving by stockholders. The tendency is to spend at least a part of the cash received as dividends. The receipt of stock dividends results in a larger proportion of savings, since if the stockholder does nothing he has in effect reinvested his dividend. In the receipt of cash, he must take positive action to effect such an investment.

2. The sale of new securities often puts cash into the treasury before it is needed. Plans for construction may be definite or only tentative, pending the success of the sale of the securities. Corporations sometimes take advantage of favorable security markets without having in mind any specific purpose which the cash is to serve.

3. The sale of capital assets brings in cash that may be needed to buy other assets or, in case the assets sold are not to be replaced, the corporation may have no specific plans for the use of the cash.

4. Savings deposited by employees and pension and other benefit funds create investment problems. These may carry obligations of both safety and liquidity.

5. Nonoperating income from various sources adds appreciably at times to surplus funds.

6. Conversion of investments into cash is made easy where investments take the form of marketable securities.

**Uses for Funds.**—Funds accumulated from the above sources may be used for one or more of many purposes, which can be roughly classified into the following groups:

1. Specific purposes calling for cash outlays at early dates. These include such items as the following:

a. Current dividend and interest payments may be anticipated by a few months. Accumulation of cash to meet them may be necessary where earnings are seasonal.

b. Funds reserved for tax payments of known amounts.

c. Contingencies, including some insurance obligations, frequently require the accumulation of enough cash to meet probable demands.

2. Specific purposes requiring cash payments at known future dates. Examples are:

a. Sinking funds.

b. Future dividend and interest payments provided for in prosperous years by cash accumulations to pay the obligations of lean years.

3. No specific purpose at times determines cash accumulations by corporations. The accumulations are accomplished because the conditions are favorable. The future is expected to provide opportunities for their use. At times, the management may have a general presentiment that existing good times cannot last forever and that it will be well to be in good cash position when the turn comes.

**Character of Investment.**—The uses to which the funds are to be put should determine the character of investment. Three possibilities are open:

1. Uses at an early date can be served by temporary investment, characterized by security and liquidity. Yield must be sacrificed to these objectives. Opportunities for such investment are offered by the following:

a. United States government certificates of indebtedness and notes.

b. United States government bonds.

c. Certificates of bank deposit.

d. Bank acceptances.

e. Call loans.

f. Commercial paper.



*g.* Corporate bonds called for redemption which have adequate funds on deposit with trustees.

*h.* Equipment trust certificates issued by high-grade railroads.

*i.* Short-term notes and early-maturity bonds issued by corporations and governmental units with strong credit standing.

2. Uses at later specific dates allow somewhat more investment latitude, though even here safety and liquidity must be emphasized.

3. Where corporate managements have at their disposal large cash accumulations for which they have no specific use, waste and speculation are apt to be the results. The suggestions made above to ensure security and liquidity of investments are not apt to carry much weight. Instead, various other policies are invited. These will be discussed briefly.

**Expansion.**—Large cash accumulations always invite expansion in inventories, in fixed capital, or both. Purchase of inventories may be in anticipation of early use or merely in anticipation of increases in price. Plant expansion may be needed to care for orders on hand, or it may be made to provide for business only hoped for. In some instances, the corporation with large cash accumulations constructs new plants as its officers and directors buy new automobiles—not that the old machine has ceased to be useful, but it is the style to buy new ones. Conservation and most efficient use of existing capital assets are not to be hoped for in the face of that feeling of prosperity which accompanies large cash surpluses.

**Absorption of Competitors.**—Large cash balances invite the absorption of competitors through purchase of their assets or their stock. Corporate managements enjoying surplus cash easily acquire the feeling that the world is their oyster. High prices demanded by competitors are no bar to purchase, for the cost is expected to be passed on to the consumers. Already satisfactory profits should be more than proportionately increased through the removal or diminution of effective competition. The pervasive optimism that surrounds cash surpluses usually brooks no opposition to size increases. The advantages of large size are uppermost. The disadvantages may have their day later—but not now.

**Branching Out.**—Investment of cash surpluses does not stop with absorption of competitors. Not only horizontal integration but vertical as well is undertaken. Control of all processes from the extraction of the raw material to the sale of the finished product is always inviting. Available cash affords the means of accepting the invitation. When circular dimensions are added to the horizontal and vertical, the opportunities for mergers and integration appear unlimited. Recent experiences of some large corporations point to their intention to try to take advantage of all opportunities offered. Many mergers of the last 20 years can be traced directly to large cash surpluses.

**Speculation.**—Purchase of assets or stock of competing or even of complementary corporations can be justified on the ground of integration. Even circular combinations have much to be said in their favor from the standpoint of profit possibilities. Some boards of directors, on the other hand, use excess cash in ways that can be described by no other term than speculation. They buy stocks of other related, or unrelated, corporations because they hope to realize a profit from stock purchase and not from business operation. The honesty of such a policy is not open to question if their own stockholders realize what is happening and give their approval to it. Purchase and sale of stocks under the guise of integration, but in reality for the speculative advantages to be gained, are open to question. Results of some of these transactions raise doubts about the ability of boards of directors to do the speculating for their stockholders.

**Research.**—There is a close correlation between research work in industry and surplus funds. Paradoxically enough, during periods when new methods and new products are most needed, research work is pushed with least vigor. Those are the times when pessimism dominates the thinking of depression-minded business executives. In prosperous times, it has been estimated, 1,000 corporations spend more than \$200,000,000 per year on industrial research.<sup>1</sup>

**Redemption of Bonds and Preferred Stock.**—The safest investment a corporation can make is the payment of its own debts. When it has surplus cash available for permanent investment, consideration should be given to the redemption of its bonds and its preferred stock. Various considerations must be taken into account before final conclusions on this subject are arrived at, among which is the retirement of the bonds or stock purchased. The corporation may wish to carry the securities purchased as treasury assets, to be sold again if occasion requires. The kind of market and its ability to absorb the probable offerings by the corporation must be given consideration. In case such securities are purchased at less than par, particularly if dividends are in arrears on preferred stock purchased, the question of fairness to present holders always arises. It is not easily answered.

In some instances, preferred stock or bonds are retired by purchase in the open market. Taking advantage of depressed prices, the Maytag Co. purchased 500,000 shares of its \$6 preferred stock in 1931. In accord with its certificate of incorporation, the Allied Chemical and Dye Corp. in 1936 redeemed its preferred stock having a par value of \$39,284,900. This resulted in a transfer of this amount from further surplus, consisting of earned surplus of subsidiaries prior to the corporation's organization and its own earned surplus thereafter, to capital surplus. In 1935, the Interlake Steamship Co.

<sup>1</sup> Graham, D., Research Expenditures and Their Effects on the General Electric Company, *Harvard Business Review*, October, 1931, pp. 118-126.

offered to buy from its stockholders, up to 40,000 shares, stock at \$35 per share provided that not more than 8 per cent of individual holdings be purchased from any one shareholder unless the entire 40,000 shares are not purchased on a prorata basis.

The U.S. Smelting Refining and Mining Co. made open-market purchases of its own stock as follows:

Year	Preferred stock		Common stock	
	Number of shares	Average price	Number of shares	Average price
1930	.....	.....	13,700	\$21.068
1931	5,500	\$38.00	16,962	14.744
1932	17,102	36.11	28,128	13.73
1933	800	41.87		

In 1933, the common stock reached a high price of \$41.11 per share.

**Capitalization.**—Frequently confusing is a derivative of the term “capital” in the form of “capitalization.” At a time when the fixed capital of a corporation was its major permanent investment, capitalization was easily defined. Then current operations were presumed to be financed by bank loans, credit from supply houses, etc. Fixed capital was financed by permanent investment and balanced by it on the books of the corporation. Short-term debt represented only the bank loans made necessary by current operations. Under such circumstances, capital could be defined as the fixed assets of the corporation. Whenever the term was used in another sense it could be qualified by some such adjective as “circulating,” “current,” or “working” to distinguish it from what was generally considered to be *the* capital, i.e., fixed capital. Capitalization then was equivalent to the valuation placed upon the fixed capital by the corporation, measured by stocks and bonds outstanding.

Under modern corporate practices, definitions are not so easily framed. Various complications stand in the way. On the assets side of the balance sheet, we find not only fixed assets and circulating capital used for current operations, but also such items as investments in nonoperating property, advances to subsidiaries and affiliates, securities owned, equities in surpluses of subsidiaries, sinking-fund investment, intangible fixed assets, and deferred charges, sometimes of sizable amounts. Even current assets now include inventories carried over from year to year, advances to affiliates, employees' and officers' accounts and notes, and marketable securities. The equities side of the balance sheet contains such items as advances from affiliated companies; officers' and employees' accounts; deferred income; reserves of various sorts, some of which anticipate long-time financing; and

various kinds and amounts of surplus. With respect to the latter account alone, recent corporate practices in crediting much of the proceeds from the sale of stock to capital surplus or paid-in surplus would invalidate the older definition of capitalization. The conditions herein described defy accurate or even useful definitions of capital and capitalization.

Every writer on corporation finance recognizes the difficulties described above but is powerless to do much about it. We still talk about under- and overcapitalization, using the same language as of old, even though we must admit that the conditions which these terms now describe are different from what was formerly the case.

**Overcapitalization.**—Under simpler corporate practices, whenever the aggregate of the par values of stocks and bonds outstanding exceeded the true value of the fixed assets, the corporation was said to be overcapitalized. The same situation was described in other terms when the stock was said to be watered. There are several disadvantages of overcapitalization, which may be classified as follows:

1. *To the Corporation.*—Stock, selling below par, tends to bring down the credit standing of the corporation. The weakened condition of the corporation's credit makes difficult the raising of new capital. To offset this weakness, maintenance is starved, depreciation charges, if any are made, are reduced, and other artificial means are used to inflate net earnings in order to make a better showing for the corporation. Even unearned and unwise dividends are used at times as pulmotors to revive the credit standing.

2. *To the Stockholders.*—Watered stock is subject to market manipulation. At the time of issue, extravagant promises of future earning power are made as inducements to purchasers. In the absence of asset values, the purchasers of stock may later find themselves holding stock that no one else wants except at very low prices. There may even be legal liability for the difference between the par value of the stock and a fair valuation of the property and services exchanged therefor, should courts of equity be asked to determine the latter.

3. *To the Consumers.*—Under monopoly conditions, overcapitalization frequently tends to raise the prices of the corporation's products and services in order to sustain dividends on too great an amount of stock. In public utilities, claims are made for a "fair return" upon the total capitalization of the corporation as if this were a proper measure of the value of the property used and useful in the service of the public. At times, indeed, capitalization has been the only available rate base. Overcapitalization in such instances is unfair to the consuming public.

**Effect of No-par Stock.**—The use of no-par stock frequently moves the tank for impounding the water from the capital stock account to a capital surplus account of some kind. Technically, the use of no-par stock results at times in a nominal stock capitalization when only a portion of the proceeds

from its sale is carried to the stock account. Suppose, for example, that the true value of the assets of a corporation is \$50,000. Suppose also that there are no bonds outstanding. If the corporation issues against these assets \$100,000 of stock, but carries to the capital account only \$5,000, placing the remainder in some surplus account, the corporation could not be said to be overcapitalized, according to the definition quoted above and still commonly used. Somewhere, however, overvalued assets are reflected in the equities side of the balance sheet. The removal of the par label dispenses with the fictitious price tag, but it does not prevent overvaluation of assets. Hence the problem of watered stock may still be present, even though its form has changed somewhat.

**Undercapitalization.**—Reversing the definition of overcapitalization, one might define undercapitalization as an excess of true asset values over the aggregate of stocks and bonds outstanding. Such conditions are rare and are easily remedied without harm to anyone. When they exist, they reflect a peculiar corporate situation such as has existed for some time in the Ford Motor Co., where the owners, all in the same family, are interested in the production and sale of motorcars and are indifferent to the clamors of the stock market. Undercapitalization of a company, whose stocks were freely bought and sold, might cause wide fluctuations in the price of shares, because of the high level at which they would change hands. Because of the high earnings ratio per share of stock, undercapitalization might unduly encourage competition. Undercapitalization of public utilities would unquestionably result in a public demand for decreases in prices paid by consumers. Excess-profits taxes tend to place unusually heavy burdens upon undercapitalized corporations.

**Bases of Capitalization.**—The aggregate amount of stocks and bonds to be issued by corporations may be determined by any one of several sets of principles, or by a combination of two or more. Among the more commonly used are the following:

1. *Cost of Property.*—This would seem to be the logical starting point. If a corporation plans to acquire property costing \$100,000, why should it not issue stocks and bonds for that amount? There are several possible answers to this question. Unless organization costs are included in the cost of the property, such a plan would leave nothing for the services of the promoter and his associates. Furthermore, paradoxical as it may seem, if a corporation should assure the prospective purchasers of its stock that every dollar collected from the sale of stocks and bonds would be used to purchase assets, it is doubtful if the market would more readily respond to such an appeal. The public is accustomed to buy inflated securities at "bargain" prices. In many instances, the amount of stocks and bonds issued is determined by the cost of the assets acquired, interpreting assets to include services. To be sure, the cost is not transferred in cash but is merely

measured in terms of cash. Property and services acquired are measured in cash, and their equivalent in stocks and bonds is exchanged for them.

2. *Value of Assets.*—The aggregate of stocks and bonds may be equivalent to the value of assets even though no exchange of property and services takes place. Value in this case would be merely an arbitrary estimate for bookkeeping purposes. The term is not synonymous with price, if by such synonym is meant that the open market would take the goods and services and pay the corporation in return the amount of cash equivalent to the book values. Valuation for the purpose of determining capitalization is frequently inflated. Occasionally, a small, closed corporation undervalues its assets and issues only a nominal amount of stock to offset them.

3. *Earning Capacity.*—Imaginations are given free rein when capitalization is based upon anticipated future earnings. After all, there is probably no better test of the value of a corporation's securities than an analysis of its earning capacity. But to evaluate the securities of a going concern in terms of its earning power is one thing; to base the securities themselves upon future earnings is quite another. The two variables are both elusive: (1) the amount and regularity of the earnings, and (2) the rate at which they shall be capitalized. The first of these, earnings, is very hard to forecast. Many factors such as public demand, competition, efficiency of management, general price levels, etc., must be taken into account. The second is never fixed but gyrates about, governed by its own set of forces, some of which are independent from those governing earnings. At one time in the business cycle, the investing public may be content with a low ratio of earnings to stock prices; at a later period, nothing short of high ratios will induce purchases of stocks or bonds.

**Relation of Stock Watering.**—Stock watering is sometimes defined as capitalization of earning power. There is an implication in this concept that hardly justifies this definition. Suppose a corporation had large asset values but little earning power. Would capitalization of its earnings result in stock watering? Or suppose a corporation possessing little asset value made consistently high earnings. Would capitalization of these earnings produce stock watering? The big questions to be raised about basing capitalization upon earnings relate rather to the accuracy with which earnings may be predicted and the rate at which earnings are to be capitalized in arriving at the value of the corporation's securities.

**Earning Capacity and Management.**—One important consideration merits particular attention in capitalizing earnings. That is the question: How much of the earnings is due to present management? The companion question would logically follow: How much could earnings be increased with more efficient management? In other words, two corporations producing similar products, in plants of equal value, and selling in competitive markets would hardly ever enjoy the same earnings. The difference must

be attributed to management. Therefore, in evaluating corporations on the basis of earning power, it is essential to weigh this factor carefully. Mergers and consolidations frequently disappoint their security owners by failure to increase, or even to maintain, the earnings enjoyed by the constituent companies before they combined. The solution to the problem may be found when a change in management is taken into account. Even if the old managers are retained, it is hard to buy the enthusiasm that they contributed to their own firms.

**Market Absorption.**—At times, it seems that the amount and kinds of securities issued by a corporation are not governed by the cost of assets, the value of assets, or the earning capacity, present or prospective. Instead, the organizers or managers of the corporation look primarily to the market for securities and ask themselves this question: What kinds of stocks and bonds will the market absorb, and how much can we sell? This is particularly true of those corporations which make more money for their promoters and organizers than for their creditors and owners. Prospectuses of such corporations give no information about assets, earning power, or total amount and kinds of securities to be issued. Promoters are not particularly interested in the first two items, and they cannot determine the third until they have gauged the market.

**Expedient Capitalization.**—When a small, close corporation, perhaps an incorporated partnership, deals with outsiders, its reputation is determined in part by the “window dressing” it uses. So far as internal relationship is concerned, it may be content with a legal minimum of stock—say \$500, divided equally among its five owners. Outsiders will be much more impressed, however, with a corporation whose advertisements read “Capitalized at \$100,000.” With no change in assets, the latter figure, rather than the former, will generally be used. For the same reasons, as the business of the corporation grows, it will increase its capitalization from time to time by the use of stock dividends, again without taking in new capital.

**Temporary Capitalizations.**—A group of men desiring to try out an invention, or explore a mine, before capitalizing it at its true value—which is as yet unknown—may find temporary incorporation at a nominal figure advantageous. Relationship of owners may be established by the apportionment of shares, liability may be limited, and costs of incorporation kept at a minimum. If hopes are realized, it is an easy matter to reincorporate or to recapitalize. For other reasons, temporary capitalization may be used as a step toward final issue of stocks and bonds. For example, the original capitalization of the U.S. Steel Corp. was \$3,000. Less than 6 weeks later, legal formalities having been complied with, the first billion-dollar industrial corporation blossomed forth.

**Haphazard Financing.**—Some corporations are at least first cousins to Topsy—they “just grewed.” The security analyst would have difficulty in

justifying, or even accounting for, the crazy-quilt patterns of their security issues. Their managers seem never to have heard the term "plan." As far as a basis for security issues is concerned, they seem to have used the first kind suggested to them. Nor is haphazard financing confined to small corporations, managed by men of limited business experience. Published balance sheets of sizable corporations sometimes display an utter lack of financial judgment in the selection of financial plans.

### QUESTIONS AND SUGGESTIONS

1. Why is it difficult to define capital?
2. What is the economist's concept of capital? Why does he not include land and accounts receivable?
3. How does the accountant define capital? Why does the businessman have no consistent definition of capital?
4. How does the lawyer define capital? What is the significance of corporate capital?
5. What terms are used to describe capital that is not classified as fixed? Which do you recommend and why?
6. List the possible kinds of current assets. Can a corporation have too much cash? Explain.
7. What determines the amount of circulating capital needed by a specific corporation?
8. How are circulating capital needs related to the budget?
9. What are the purposes for which circulating capital is acquired?
10. In acquiring circulating capital, what kinds of investment policies are possible? Which do you recommend? Why?
11. What is the meaning of surplus funds? What are their sources? What are their uses? How should they be invested pending their use?
12. Which specific uses do you recommend? Which do you question? Why?
13. What is the meaning of capitalization? Why is it difficult to define this term?
14. Define overcapitalization, and state whose interests may be adversely affected by it.
15. How has the use of no-par stock affected overcapitalization?
16. What is undercapitalization, and why is it practiced?
17. What are the possible bases of capitalization?
18. How is earning capacity related to management?
19. Why are some corporations financed only temporarily?

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### SUBJECTS FOR INVESTIGATION

1. From the current issues of the *Commercial and Financial Chronicle* or from a recent manual, select a balance sheet of a well-known industrial corporation. Which asset items indicate fixed capital used by the corporation for the production or distribution of goods and services?
2. Which asset items indicate circulating capital? Characterize each of the other items.
3. Do you think this corporation is either undercapitalized or overcapitalized? Justify your answer.

## CHAPTER XX

### THE MARKET FOR SECURITIES

**Investable Surplus.**—Capitalism is variously defined as a system of government, a type of social organization, etc. From the point of view of corporation finance, it signifies two things unrelated to much of the controversy surrounding the term. In the first place, a capitalistic system of economics is one that makes large use of capital as an aid to labor. In the second place, much of this capital is privately owned by people who enjoy the results of its accumulation. Before there can be an accumulation, someone must have an investable surplus—a favorable difference between his receipts and his expenditures.

The rapidity with which the wealth of the United States has assumed the intangible form of securities is almost unbelievable. Less than a century ago only one-sixth of our total wealth was in the form of securities. Even a third of a century ago the proportion had risen to less than one-fourth. But by 1932, three-fourths of our total wealth was estimated to be in the form of securities.<sup>1</sup> The amount of money available for investment in corporate securities varies with the total income of our people. The degree of variation is not direct, however. One investigator found, for example, that in the decade from 1919 to 1929 the national income increased 25 per cent, while the volume of new security issues for the same period increased 274 per cent. The volume of new securities during this decade did not represent new capital financing in all cases because of the amount of refunding in one form or another. Nevertheless, the amount of new capital financing was still very large. Conversely, in the years from 1929 to 1932 national income decreased 53 per cent; the volume of new securities decreased 97 per cent.<sup>2</sup>

**Securities Outstanding.**—There is no available census of the total securities outstanding for all American corporations. In considering the total volume of stocks and bonds, however, useful indices can be relied upon. The following statistics are presented as such. According to Moody, the stock capitalization of American corporations listed on the New York Stock Exchange in 1930, the peak year before the depression, was as follows:

<sup>1</sup> Edwards, G. W., Control of the Security-investment System, *Harvard Business Review*, October, 1933.

<sup>2</sup> Weidenhammer, Robert, Control of New Investment, *Annals of the American Academy of Political and Social Science*, January, 1934, pp. 73-82.

Industrial Classification	Stock (000,000,000 omitted)		Surplus
	Preferred	Common	
Railroads.....	\$ 2.1	\$ 8 0	\$ 5.5
Utilities.....	3.1	14.1	6.6
Industrials.....	10.1	44.5	26.9
Financial and real estate.....	3.8	20 5	16.2
Total.....	\$19.1	\$87.1	\$55.2

The amount of corporate debt for the same year was as follows:

	(000,000,000 omitted)
Railroads.....	\$11.8
Utilities.....	14.1
Industrials.....	10.8
Financial and real estate.....	11.1
Total.....	\$47.8

The *Federal Reserve Bulletin* for July, 1946, published the following interesting estimated consolidated balance sheet for nonfinancial corporations:

ASSETS		LIABILITIES AND NET WORTH	
	(000,000,000 omitted)		
Cash.....	\$ 23	Notes and accounts payable.....	\$ 26
U.S. Government securities.....	21	Advances from U.S. Government..	1
Receivables:		Accrued Federal income taxes.....	11
U.S. Government.....	3	Other current liabilities.....	8
Other.....	23	Total current liabilities.....	46
Inventories.....	26	Long-term debt and capital stock..	125
Other current assets.....	2	Surplus and capital reserves.....	64
Total current assets.....	98	Total liabilities and net worth...	\$235
Plant and equipment		Working capital (current assets)	
(depreciated).....	94	minus current liabilities).....	\$ 52
Other assets.....	43		
Total assets.....	\$235		

According to the *Survey of Current Business* for July, 1944, the corporate long-term debt of the United States was \$51 billion and the short-term debt was \$50.8 billion. The corresponding amounts for 1943 were \$42.6 billion and \$35.8 billion, respectively.

The *Commercial and Financial Chronicle* reports the following amounts of corporate securities issued by years from 1934 to 1945:

## DOMESTIC CORPORATE ISSUES (MILLIONS)

Year	Bonds and notes	Preferred stock	Common stock	Total
1934	\$ 456	\$ 3	\$ 31	\$ 490
1935	2,117	124	27	2,267
1936	4,026	271	282	4,579
1937	1,673	468	292	2,434
1938	2,043	79	19	2,140
1939	1,833	161	73	2,117
1940	2,435	246	82	2,762
1941	2,320	219	80	2,619
1942	913	110	19	1,042
1943	887	131	43	1,061
1944	2,605	411	101	3,117
1945	4,858	1,031	278	6,166

The *Federal Reserve Bulletin* for July, 1946, quotes the following amounts of corporate security issues in the United States for the purpose of securing new money:

## Monthly averages, millions

Period	Total new money		For plant and equipment		Working capital	
	All corporations	Industrials	All corporations	Industrials	All corporations	Industrials
1941.....	\$72	\$20	\$55	\$ 9	\$17	\$12
1942.....	39	24	24	10	16	15
1943.....	26	19	12	7	14	12
1944.....	55	38	21	10	34	27
1945 (1st half) ..	59	44	27	17	32	26
1945 (2d half)....	107	78	70	51	37	28
1946 (1st half)...	130	115	80	75	50	40

**Diffusion of Ownership.**—The lists of stockholders of some of America's largest corporations read almost like a census roll, with several hundred thousand names on each of such lists. Lacking accurate statistics on the subject, various students have undertaken estimates of the time. One estimate suggests the probability of 9,000,000 stockholders in 1930.<sup>1</sup> Another includes duplications of those holding stock in more than one corporation and reaches a total of 18,000,000 in 1928.<sup>2</sup>

<sup>1</sup> The Twentieth Century Fund, "The Security Markets" (New York, 1935), p. 50.

<sup>2</sup> Means, Gardiner C., *Diffusion of Stock Ownership in the United States*, *Quarterly Journal of Economics*, August, 1930, p. 565.

The greatest impetus to diffusion of ownership of securities of American corporations came in the decade following the First World War. A number of factors contributed to this end. The widespread distribution of Liberty bonds had taught millions of investors to look for evidence of ownership in the form of a bond. It was an easy step from Liberty bond ownership to the purchase of corporate bonds and stock. The popularity of customer and employee ownership of shares in the decade following 1920 was also a contributing cause. It has been estimated that the number of shareholders in 1928 was three times as great as in 1900.<sup>1</sup>

It is a curious fact that the number of registered shareholders increases during periods of depressions. This is due largely to three causes: (1) In a period of prosperity, a great many people who own stock outright fail to have it registered in their own names because they hope to sell it soon at a higher price. (2) When falling prices accompany a period of depression, many margin traders pay for their commitments in full and take the stock in their own names expecting a long period ahead before they will be able to sell to advantage. (3) Bargain hunters who buy for cash and expect to hold for the long pull take their stock out of the market and hold it in their own names until they think they see a favorable opportunity to sell.

**Classes of Security Buyers.**—The original source of funds for security purchases is the investable surpluses of individuals and organized groups such as corporations, associations, etc. Sometimes these surpluses are aggregated in some manner before they are used to purchase securities. A suggestive classification of security buyers is as follows:<sup>2</sup>

1. Institutional or professional buyers—those who are themselves reasonably familiar with the character of the merchandise they are purchasing and are more or less able to judge it. In this class may be included:

a. Banks, investment trusts, insurance companies, and other financial establishments which purchase for their own account and risk.

b. Trust companies and other fiduciaries which purchase on behalf of the owners of funds that have been entrusted to their care.

c. Special investment buyers, such as insurance companies, which have very clearly defined needs and buy securities with a view to meeting highly technical requirements.

2. Trade buyers who purchase with a view to retailing or disposing of the securities. Among these may be recognized the following groups:

a. Investment houses which deal with small investors and resell to them at a moderate commission securities which they themselves have purchased in the first instance.

b. Individual purchasers of a semispeculative type who are buying with a view to probable appreciation.

3. General investment buyers, including:

<sup>1</sup> The Twentieth Century Fund, *op. cit.*, p. 166.

<sup>2</sup> Willis, H. P., and J. I. Bogen, "Investment Banking" (New York, 1929), pp. 428-429.

a. Individuals who have a surplus of income over expenditures, or who are in possession of accumulated funds that they wish to use as a basis for income.

b. Business establishments that find themselves from time to time with surplus funds in hand and, not wishing to leave these funds idle or producing only a nominal income as they might if deposited in a bank at interest, prefer to purchase securities with them.

**Institutional Buyers.**—Institutional buyers of securities are differentiated from other classes by something more than acquaintanceship with securities purchased. Their fiduciary relationship to those who supply, and still own, the funds invested by financial institutions makes the latter cautious about taking risks. On the other hand, their obligations to those whom they serve are dollar obligations only and are not affected by changes in purchasing power. An insurance company that agrees to pay \$1,000 at the death of a policyholder is expected to pay \$1,000 in money. Whether that amount will buy  $X$  quantity of consumption goods or  $4X$  quantity is of no concern to the insurance company. A trustee of an estate is expected to conserve dollar values: he has no obligation to increase the estate. This emphasis upon dollar obligations helps to explain the kind of security market furnished by financial institutions. Indeed, the assumption that attempts to make investments in terms of purchasing power carry too great risk has been written into much of our legislation governing institutional investments. For example, American life insurance companies as a rule are not permitted to purchase common stocks. The relatively small surplus of life insurance companies over their fixed liability to policyholders leaves little cushion to absorb large losses in investment accounts. This condition is further aggravated in the case of mutual companies which do not retain all their earnings.

**Trade Buyers.**—Trade buyers of new security issues correspond to floor traders on the stock exchange or operators in the real estate markets. Buying for the most part for a quick turn, they stand ready to purchase those securities which most readily appeal to buyers at the time. On the chance that they may not meet with immediate success in their efforts at resale, they will of course not overlook other elements of value. But the attention of trade buyers is centered upon resale.

**Individuals.**—Individual purchasers of securities are legion and represent in their tastes the whole gamut of investment temperaments. Their number is uncertain. Before the First World War, they probably did not exceed a few hundred thousand. The widespread distribution of Liberty bonds taught 20,000,000 people that property values may be evidenced by a bit of paper called a bond. Security salesmen have been capitalizing this education ever since. It is likely that nearly the same number have since purchased corporate stocks and/or bonds. Not all these buy newly issued securities. Many buy only listed securities. However, there is considerable

fluidity in security-purchase preference, so that purchasers of listed securities at one time may buy bonds or stocks of a new issue at another.

**Investment Preferences.**—Many factors determine investment preferences of individuals as well as of institutions. Prejudice plays a large part. Few individuals act on the basis of cold-blooded reasoning, even when investment of money is involved. The security stylist has problems similar to those of the wearing-apparel business, with this important difference: It is difficult to set new fashions in investments. A purchaser of real estate mortgages is apt to overlook all other investment opportunities as long as he receives satisfaction from the investments he holds. When defaults cost him money, he will be inclined to switch to corporation bonds or something else. Or the bond purchaser continues to buy bonds with his savings until the pressure for enjoying some of the profits accruing to his stock-purchasing friends becomes too great to resist.

Another factor that influences the reluctance to change investment preferences is unfamiliarity. Most people lack the courage to try something new. Acquaintance, whether direct or indirect, banishes fear and instills confidence. In time, insistent propaganda wears away resistance. As a net result, ignorance, prejudice, indifference, restricted opportunities, and what not—all combine to maintain existing investment fashions, but eventually the new styles make the greater appeal.

**Stock-mindedness.**—During periods of prosperity, with consequent increasing security prices, many individual security purchasers succumb to stock-mindedness. By this is meant that the comparative security of principal and steadiness of yield of bonds no longer attract as they once did. High incomes, particularly in the decade following the First World War, made investable surpluses available to more people than ever before. The prevalence of installment buying made possible a higher standard of living, maintained from current income which was still large enough to permit the accumulation of funds for investment purposes. The purchases necessary to sustain the increased standard of living in turn produced an unprecedented period of prosperity, which caused stock prices to soar to heights hitherto unreachd. Week by week, month by month, and year after year new highs were recorded in the stock markets. The possession of money with which to buy, combined with what appeared to be unlimited opportunities for profit, caused staid bond and mortgage buyers to become stock-minded.

**Vicarious Pioneering.**—For the most part, the frontiers of American civilization are well subdued. The restless spirits who, until a generation ago, could "go West," where they could find outlets for their abounding energy in solving the many new problems pressing for solution, find today that the West is East so far as the character of the civilization is concerned. Traffic congestion and racketeering are no longer monopolized by the older cities. Even Wild West picture shows have lost much of their wildness.

Only the ten-year-old boy with a new wooden gun any longer makes serious plans for raids against the Indians.

Shades of our forefathers stalk among us and urge us to accomplishments outside of ourselves. We want to take a chance and leave the road that leads to security and mediocrity. The pulse-quickenings stories of giant corporations have fired our imaginations and given us the opportunity to do a bit of vicarious pioneering by inviting us to join forces with American business in its march to new markets and in its forays to bring back to the owners new profits in return for their participation in the venture. Many purchasers of stock disregard the income return from dividend checks, pay no attention to proxies that give them the right to vote at stockholders' meetings, but pay daily, if not hourly, attention to market quotations that tell what is happening to "their" corporation.

**Sound Psychology.**—Promoters and security salesmen who play upon the emotions in their stock-selling campaigns have a sound psychological background for their appeals. Safety and security are enjoyments to look forward to—not to be experienced in the present. Until we reach middle life, we seldom give security a second thought. We are too much engrossed in the thrills of youth. Later, we think of and even plan for security—for the future. Meantime, security is a relative concept. It can be attained at different levels. Security for the man of meager income has modest proportions. As a given goal is approached, it is supplanted by a more desirable one, farther away. A "nest egg" of \$1,000 looms large to the man without means. Should fortune smile upon him, the \$1,000 changes successively to \$5,000, \$10,000, \$50,000, etc., indefinitely. Slow, humdrum pursuit of any given goal never satisfies. Short cuts are sought after. The appeal of common stocks receives cordial reception.

**Listing of Securities.**—Any device that results in making sales of securities more easily consummated, or in broadcasting information about security prices, increases public interest in securities markets. The listing of securities for sale on organized exchanges widens the market for all securities, listed and unlisted. Because of the listing requirements of the exchange managements, more confidence is inspired in the minds of the investing public. The publicity resulting from exchange transactions has an educational and advertising effect. People who might not otherwise become interested in the purchase of securities learn about them from daily stock reports and newspaper publicity concerning market activity. Interest frequently develops into action merely through the contagious influence of watching stocks go up.

**Business Establishments.**—Corporations sometimes use their idle cash for security purchases. The policies that determine such investments are so important in corporation finance that their discussion is reserved to a later chapter.



**Classes of Securities.**—The securities offered in the market at any time may be classified variously. For our present purposes the following classification appears to be useful:

1. *High-grade Securities.*—The characteristic that distinguishes this class of securities from others is the relative certainty of payment of its contractual obligations. Both income and principal installments are quite well assured. Such securities are confined to the seasoned issues of corporations with stabilized earnings in mature industries. The better classes of bonds and, less frequently, preferred stocks are included in this group.

2. *Low-grade Securities.*—In contrast with high-grade securities, those classed as low-grade are characterized by uncertainty. They represent ownership equities and, at times, creditors' claims against corporations whose earnings and future progress cannot be foretold with accuracy. Several conditions bring this about: They may be issued by new corporations in new industrial fields. They may be issued by corporations, the demand for whose products is highly irregular. They may represent ownership and creditorship of corporations that are on the down grade. The low-grade securities of today may become high-grade tomorrow. Also, the high-grade securities of today may be classed as low-grade tomorrow.

3. *"Low-down" Securities.*—In the definition of low-grade securities, there was no implication of fraud. With the best of intentions, their issuers cannot, in the nature of things, assure their outcome in the future because there is no means of foretelling it, even approximately. The chief characteristic of low-down securities is their "certainty." In the minds of their promoters, there can be no uncertainty as to the investment qualities of the securities offered. Because such securities are issued with fraudulent intent, the purchasers are bound to lose. Their losses are limited by their commitments.

**Sale by Promoters.**—Occasionally, with small corporations of a highly speculative character, the promoter may dispose of his securities directly by sale to his friends and to their friends. Less frequently he may attempt to build up a sales organization for direct sale to the general public. Sometimes he is able to dispose of blocks of stock to other security salesmen. It seems likely that recently enacted Federal legislation will eliminate much selling of securities by promoters. It impinges particularly upon the flotation of securities of new corporations. Since the total volume of securities sold for new corporations will be definitely decreased, the amount to be sold by promoters will necessarily decrease also.

**Direct Selling by Corporations.**—For various reasons, corporations sometimes undertake the direct sale of their own securities. The issue to be disposed of may be too small or too speculative to attract the attention of organized security-sales organizations. Where a corporation undertakes the sale in order to save itself a sales commission, it may

meet with disappointment. The arguments against such direct sale are as follows:

1. The alleged economy may be false. A corporation engaged in manufacturing automobiles, or any other product, is apt to be wholly inexperienced in, and unprepared for, the marketing of securities. It is not acquainted with the investment markets and has no salesmen trained in the work to be done, no clientele ready to give favorable consideration to its offerings, and no means of protecting those who purchase its securities. If it performs the same services offered by investment bankers, it is doubtful that it could compete with them on the cost of such services.

2. Many investors are prejudiced against the purchase of securities directly from the issuing corporations. They frequently assume that the absence of support of an investment banker indicates that the securities offered lack those qualities which could attract such support. They are more likely to buy a security because of the prestige of the investment banker that offers it for sale than because they have faith in the issuing corporation. Not only may the sale through investment bankers be more successful, but higher prices may be obtained for the securities sold.

3. Investment bankers seldom enjoy the role of lifesavers. If their services are requested only in emergencies that cannot be met by the corporation by other means, they may be unwilling to respond to such calls. Payment of sales commissions may act like insurance premiums, ensuring the corporation later support if a time of need should arrive. The advice of organized security dealers in selecting the particular type of security to be offered may well be worth more than the amount of the sales commission. The timing of the security sale may be gauged better by those operating in the securities market regularly.

4. Securities sold directly may be less easily digested than those sold through reputable banking houses. The clientele of the latter are more apt to be security purchasers who are accustomed to invest their money in this manner. The purchasers of securities directly from the issuing corporation may be mere speculators, hoping for a quick turn. If these hopes are not realized, disappointment follows, and the market may be flooded with securities for which there is little demand and no machinery set up for absorbing them. Securities sold through organized security dealers are often given the advantage of market support until they have found places in the strong boxes of purchasers who expect to hold them for a considerable period of time. The method of providing this market support is described in the succeeding chapter.

5. Attempts at direct sale of securities may be unsuccessful. In this event, two results would follow, both embarrassing to the issuing corporations: (1) The money needed and perhaps already spent would not be

available. (2) After the corporation had failed to sell its own securities, it would be difficult for any other organization to succeed in selling them, even if it could be induced to try. Meantime the corporation may have contracted to spend the money that it hopes to receive from the sale of its securities. With definite commitments for the expenditure of the proceeds of the sale of the security issue, the corporation can ill afford to risk failure in the disposal of its securities.

**Special Security Sales.**—There are, however, four sets of circumstances under which a corporation is most likely to succeed in offering to sell its securities directly. One is the sale of stock to present holders under circumstances that they can scarcely afford not to take advantage of. This will be described in a later chapter. Two others include the sale of stock to employees and to customers. In both of the latter cases, there is involved more than the mere financing of the enterprise, as will be shown in the following discussion. The fourth is the private sale, described later in this chapter.

**Sale to Employees.**—The decade of the 1920's witnessed the most common use of the practice of selling stock to employees by corporations for whom they worked. While this kind of security sale had been in use for some years previously, it was adopted by a larger number of companies in the 1920's. Of several hundred corporations studied by the National Industrial Conference Board in the latter part of this decade, it was estimated that approximately one-third of the employees were stock purchasers. In 1936, 50,865 employees of the United States Steel Corp. owned 70,298 shares of its preferred stock and 745,085 shares of its common. From 1901, when this corporation inaugurated its plan of selling stock to its employees, to 1935 when it abandoned the plan, employees contracted to purchase 350,000 shares of preferred stock and 2,300,000 shares of common. Other well-known corporations that adopted similar plans included the companies in the American Telephone and Telegraph system, General Motors Corp., American Tobacco Co., Procter and Gamble, Firestone Tire and Rubber Co., Dennison Manufacturing Co., Sears, Roebuck and Co., and E. I. du Pont de Nemours & Co. Only a few railroad corporations ever tried employee-ownership plans.

In most cases, stock offered to employees made no distinction as to purchasers, giving all an opportunity to share in the ownership of the corporation. In a minority of cases, restrictions were imposed, either in the nature of singling out the classes of employees eligible to buy stock from the corporation, of establishing minimum length of service, or minimum or maximum income from the corporation, etc. In most cases common stock was the type of security sold, while in some cases preferred was used instead. In a few instances, special types of securities were available only to employees.

For the most part, stock sold to employees was purchased in the open market for that purpose. This avoided the trouble of obtaining from other stockholders a waiver of their rights to subscribe to any unissued stock. It also made possible the sale of stock to employees at whatever price the corporate management saw fit to fix. As a matter of fact, it was not unusual to change the price from time to time. Some corporations sold stock to their employees at less than the market price at the time of the purchase. Others simply assisted their employees to buy at market prices. In some cases the corporation merely carried the installment account for the employees who, in effect, purchased the stock in the open market. In almost all cases, the stock was purchased on some kind of installment plan, with a period of one to several years allotted to complete the purchase. Some corporations, like the U.S. Steel Corp., helped their employees pay for the stock by matching some of the early payments. In other instances, such as the General Motors plan, the employee stock was given extra dividends for a few years after purchase.

**Reasons for Use.**—While employee ownership of stock may be looked upon as a means of effecting a wider diffusion of stock ownership, it was not ordinarily accomplished as an economical method of raising funds. As a matter of fact, it was seldom used primarily to raise capital. The testimony of the Standard Oil Co. of Indiana is probably typical. In selling \$10,000,000 of its stock to its employees and to those of its subsidiaries, it indicated that the proceeds would be added to its working capital “as a matter of course and not because additional working capital is needed.” A more common purpose was the creation of industrial good will, by making the employees feel that their interests are best served by the good fortunes of their employer and that they will share such good fortunes as part owners. In adopting employee stock-purchase plans, corporations hoped to reduce labor turnover, increase the efficiency of their operations, and improve employer-employee relations generally.

From the standpoint of employees, they were encouraged to adopt methods of improving their earning capacity by the amount of the dividends on their stock and to employ a part of their earnings to build up some kind of estate outside their wage-earning capacities. Perhaps they gained something from the adoption of thrifty habits and from having a proprietorship interest in the business with which they were associated. The actual results of the latter are hard to evaluate. Even in such a case as the Dennison Manufacturing Co., it is doubtful if the employees outside the management group learn a great deal about the business problems of the corporation. All Dennison common stock is owned by the employees. The principal employees own “management” stock which ordinarily casts the votes; other employees own “employee” stock.

**Results.**—The results of employee stock ownership have not always been too happy. In cases where employee purchases have proved unprofitable, industrial good will may easily become ill will. To avoid this possibility, some plans contemplate a sort of underwriting of losses by the management. This can be accomplished by selling the employees especially well-protected securities or by repurchasing them without loss to the employees. In 1928, the Great Atlantic and Pacific Tea Co. sold to its employees nonvoting stock at \$90 per share. In 1936, the company offered to repurchase the stock at the original price. At the time the offer was made, the stock was selling on the New York Curb at \$85.50 per share.

The consequences of the 1929 stock-market crash brought an abrupt end to many employee stock-purchase plans. Managements saw no effective means of offsetting the consequences of such a debacle. For example, at a time when the common stock of the United States Steel Corp. was selling on the market for nearly \$200 per share, it was offered by the company to its employees at \$169. The high price of this stock in 1933 was only \$67.50 per share, while it sank as low as \$23.375 during the same year. As a result of many similar breaks in security prices, a great many corporations abandoned, during the decade of the 1930's, all attempts to sell stock to their employees. The optimism of the preceding decade had been succeeded by distinct bewilderment after the tremendous tumble in the price of stocks.

Undoubtedly another factor that has helped to cause a decline in the popularity of employee stock-purchase plans is the attitude of the leaders of organized labor. They look upon all such programs as blows aimed at the class consciousness among wage earners which they persistently try to develop. In other words, they see in the success of employee stock ownership a definite assault upon the principles of unionism. Groups interested in the sale of securities for corporations are also inclined to look with disfavor upon employee stock-purchase plans. They point out that little capital can be obtained from this source at the time when it is needed most; while at the time the employees are best able to buy stock, the corporation does not need the added capital. This argument should not be taken too seriously, however, since it has already been pointed out that no corporation looks upon employee stock-purchase plans primarily from the standpoint of raising its capital by this means.

**Customer Ownership.**—Closely akin to the sale of stock to employees is the practice of selling securities to the customers of the corporation. This subject belongs properly under two heads: sale to ordinary consumers of the product, such as the domestic consumers of gas; and sale to the business enterprises which purchase for resale the products of a manufacturing concern. Public utility corporations, particularly, have found the sale of securities to their consumers both an economical method of obtaining capital

and a means of accomplishing other objectives as well. Consumers of the services of public utilities occupy a dual role: they are consumers of gas, electricity, etc., but they are also voters who help to determine public attitudes toward public utility regulation. If they can be induced to adopt the public utility corporation's point of view as owners of its securities, they will cause less clamor for decreases in rates or improvement in service. During the decade of the 1920's, 2,500,000 sales of public utility stock, averaging slightly more than 10 shares per sale and aggregating more than \$2,000,000,000 in par value, were made to consumers.

For the most part, the utility stock sold to consumers was preferred stock, until the latter part of the 1920 decade when even such purchasers began to demand common stock. By offering preferred stock, old stockholders were not required to give their consent to a sale to a special group of consumers. Also there was presumed to be more security attached to preferred stock, so that a break in the stock market would not create the opposite effect from the one intended when the stock was sold to consumers. Even such stock, however, gave no assurance of stability in price. For example, from 1925 to 1928 the Philadelphia Rapid Transit Co. sold 280,000 shares of 7 per cent cumulative preferred stock, for \$50 per share. Most of the 22,500 purchasers were car riders, many of whom paid for their purchases at the rate of \$1 per share per week, payable on the company's cars. This company went into receivership in the early 1930's and, as a consequence, its preferred stock sold at very low prices, even before the company was reorganized. Other public utility corporations have offered little stock to customers since the stock-market break in 1929. Because of the possibilities of such breaks, there is considerable doubt whether the consumer good will that is purchased by the sale of stock is permanent or effective. Also it is probable that the Securities and Exchange Commission will scrutinize quite carefully plans for the sale of stock to customers hereafter, both under the Securities Act of 1933 and the Public Utility Holding Company Act of 1935.

Outside the field of public utilities, relatively little use has been made of plans to sell stock to customers or consumers. In a few instances, manufacturers have tried to weld a close bond between themselves and the distributors of their products by selling blocks of stock to the latter. The original United Drug Co. introduced a plan by which drugstores that sold its products and featured the name Rexall would own a part of its stock. When Grigsby Grunow Co. merged with the Household Utilities Corp., the combination first offered its mortgage bonds to a group that included its distributors. This kind of financing has not been common in the field of industrial corporations.

**Private Sales.**—A new method of disposing of entire issues of bonds to a single buyer or a few buyers was introduced in the decade of the 1930's. Before the break in the stock market in 1929, it had been customary for large

of first 4½s sold by the Guilford Water Co. The largest one amounted to \$114,500,000 and was offered by the Commonwealth Edison Co. In more recent years, even larger issues have been sold privately. For example, in August, 1946, General Motors Corp. sold \$125,000,000 long-term notes to eight insurance companies. Of this amount, \$96,000,000 matures in 1976 and \$29,000,000 in 1966. The former was sold at 99½, the latter at 100¾. The rate of interest is 2½ per cent in both cases. It is interesting to note that the percentage of private sales of bonds to the total offered for the years 1934 to 1939 increased from 19 in the earlier year to 33 in the later year. Railroad corporations placed the smallest proportion of their bonds privately—18 per cent in number of issues and 10 per cent in dollar volume. Public utilities placed about half of their issues, both number and volume, privately during these years. Industrial corporations placed privately about one-third of their number of issues, involving about two-fifths of their dollar volume.

According to the *Commercial and Financial Chronicle*,<sup>1</sup> the amounts of private subscriptions for each of the years 1937 to 1945 were as follows:

Year	Number of issues	Volume	
		Millions of dollars	Percentage of total issues
1937	117	456	18.7
1938	127	681	31.8
1939	137	729	33.2
1940	157	835	30.2
1941	215	957	36.6
1942	93	434	41.6
1943	55	273	25.2
1944	140	870	27.4
1945	160	1,250	20.1

The industrial distribution of bonds sold by private subscription is accounted for in part by the fact that the purchasers are usually insurance companies. In fact, approximately 85 per cent of a selected list of more than \$1,000,000,000 of bonds placed privately were sold to the so-called "Big Five" companies, which include the New York Life Insurance Co., the Prudential Life Insurance Co., the Metropolitan Life Insurance Co., the Equitable Life Assurance Society of the United States, and the Northwestern Mutual Life Insurance Co. For some years, the portfolios of these companies have been lightening their holdings of railroad bonds rather than adding to them. Also, however, it should be noted that the Interstate

<sup>1</sup> January 28, 1946, p. 508.

Commerce Commission does not look with great approval upon the private sale of railroad bonds.

One-fourth of the number of bond issues sold privately in the years 1934 to 1939—but less than 2 per cent in dollar volume—were for less than \$1,000,000 each. More than half the number and nearly one-third of the dollar volume ranged from \$1,000,000 to \$10,000,000 per issue. And a bit less than one-fifth in number but two-thirds in dollar volume were over \$10,000,000 per issue. Nearly two-thirds of the total volume of bonds sold privately were for refunding purposes. Even here, however, there was not a complete change in bond ownership since the same insurance companies that bought the new bond issues probably held a large percentage of the bonds that were refunded. In addition to the bonds purchased privately, the insurance companies purchased during the same period approximately half the bonds offered publicly.

**Possible Disadvantages.**—The rapid growth of private sales of bonds during the decade of the 1930's raises some interesting questions concerning the possible disadvantages of this method of raising capital. In the first place, the tremendous volume of such sales calls sharp attention to the changing nature of our economy, with the great emphasis upon large aggregates of capital resources in the portfolios of large investment institutions like insurance companies. The chief significance lies in the general acceptance by large numbers of capitalists of the services of these large companies, in acting as investment agents for those whose resources they manage. It is still private ownership that is involved, but there has been a great change in the concept of individual initiative in the management of private capitalism. In addition to this evidence of the increasing concentration of the control of private wealth, other questions are raised about the policy of selling securities directly by the issuer. It is well for the reader to keep in mind this growing concentration of bond ownership because many of the criticisms that are made of private sales of bonds fall of their own weight in the light of this concentration.

Some critics question the economies in time and money when bonds are sold privately. The preponderance of evidence, however, seems to support the contentions that the issuing corporation is saved time, money, and trouble in making its arrangements to sell its bonds privately. Even the adjustments that have been made by the Securities and Exchange Commission in expediting the approval of public offerings still seems to leave a balance of time and money in favor of the private offerings. Other criticisms that have been leveled against private offerings are more serious.

**To Issuing Corporation.**—It is contended that the sale of bonds privately destroys the public market for future issues of securities by the same corporation. Against this there is the contention that the purchase of an entire bond issue by one or only a few buyers places the hallmark of security on



the corporation's credit. Then too it must be remembered that even at a public offering the buyer of a good share of the bonds offered would probably be the same insurance company that purchased the privately placed issue. A study made by the Securities and Exchange Commission of several representative bond issues floated during 1938 showed that approximately 85 per cent of the total amount of bonds offered for sale were purchased by banks and insurance companies. Individuals, on the average, bought only 6.6 per cent of the bonds from the distributors.<sup>1</sup> However, it should be pointed out that banks did not hold their securities as did the insurance companies. It was not unusual for banks to dispose of their purchases within a few weeks. In many instances, the resales were made to bank customers without any direct profit on their sales. It should be noted also that banks frequently resold such securities to insurance companies. For example, banks that purchased large amounts of the bonds listed in the following table resold them under orders dated not later than one week after public offering, as follows:<sup>2</sup>

Issue	Percentage of total resales by banks to		
	Insurance companies	Other banks and trust companies	Individuals
Toledo Edison, 3½s, 1968.....	43	21	3
Atlantic Refining, 3s, 1953.....	48	16	3
C. & O. Ry., 3½s, 1963.....	74	16	10
U.S. Steel, 3¼s, 1948.....	7	39	9

The large amounts held by insurance companies of bond issues that attracted their attention, together with the evidence of purchases subsequent to the original distribution of additional bonds, is shown by the following table:<sup>3</sup>

Issue (amount in millions)	Percentage of issue	
	Purchased from distributing groups	Held on Dec. 31, 1938
Toledo Edison, \$30, 3½s, 1968.....	26.7	46.1
Atlantic Refining, \$25, 3s, 1953.....	29.6	40.6
U.S. Steel, \$100, 3¼s, 1948.....	16.5	20.9
A. T. & T., \$140, 3¼s, 1966.....	36.0	56.2
Phila. Elec., \$130, 3½s, 1967.....	45.8	58.6

<sup>1</sup> T.N.E.C. *Hearings*, Part 24, U.S. Government Printing Office, 1940, p. 12707.

<sup>2</sup> *Ibid.*, pp. 13021ff.

<sup>3</sup> *Ibid.*, p. 13029.

A disadvantage of more weight to the issuing corporation probably is the inability to repurchase bonds needed for sinking-fund requirements. If the issue is placed privately, it is not so likely that the corporation can buy in the open market the bonds it needs to build up its sinking fund. Nor can it repurchase its own bonds at a distinct market advantage during depressions. Purchasers of bonds at private sale are less likely to wish to resell them than are miscellaneous purchasers at a public offering. On the other hand, probably not many corporations would be in a favorable financial position during depressions when their bonds might be selling at a low price. Another criticism made of private sales is that, if the issuing corporation deals directly with the purchasers, without making use of the services of an investment banker, the latter will hesitate to render a later service to the corporation if it should be needed.

**To the Buyer.**—There are several alleged disadvantages to the buyer of bonds purchased at private sale. Since such bonds have never been offered in the market, they might not be easily marketed should the buyer need additional liquidity. The same could be said for the real estate mortgages that it holds. On the other hand, its privately purchased bonds would constitute only a fraction of its total investment portfolio so that it would normally have other means of acquiring liquidity. However, arrangements are usually made to secure subsequent registration with the Securities and Exchange Commission for bonds sold privately. Also the contract of original sale provides for exchange with the issuing corporation for bonds of smaller denominations, should the purchaser wish to resell any part of the issue.

**To Other Investors.**—It is sometimes contended that private sale of corporate bond issues to one or a few large insurance companies deprives other investors, including small institutions, of an opportunity to purchase high-grade bonds. There may be some truth in this criticism. It should be noted, however, that the assumption that all high-grade bond issues are placed privately is not borne out by the evidence. Also the reader is reminded again that the greatest purchasers of publicly offered bond issues are the same insurance companies that buy those which are sold privately. It is contended also that the sale of bond issues privately tends to cause the abandonment of the machinery for the public offering of bonds, thereby reducing the opportunities for private individuals to purchase high-grade bonds in the open market. Let us not confuse cause and effect. It was the original abandonment of individual purchases of bonds and the development of the substitute of turning funds over to institutional investors that created such large reservoirs of investment funds in the coffers of insurance companies and other financial institutions. If the investment public chooses this method of investing its money, there will continue to be changes in the machinery of the bond market.

**Limitations.**—In concluding this analysis of the private sales of security issues, several limitations should be noted. In the first place, only a relatively small number of the best known corporations have the opportunity of taking advantage of this method of raising capital. The great mass of corporations could not hope to sell their bonds privately. In the second place, only high-grade bonds will be bought in this manner. Second-grade bonds and all classes of stock will continue to be sold by other methods.

**Term Bank Loans.**—Another form of private subscription that is becoming more common in recent years is the term loan obtained from one or a few commercial banks. Some of the larger corporations find it convenient to make such loans either as a substitute for the type of private subscription described above or as a supplement to it. Such loans frequently cover a period of 5 to 10 years. They are commonly serial loans, being amortized over the life of the loan. It is not uncommon for the borrowing corporation to arrange simultaneously for term loans from both commercial banks and insurance companies, with the former taking the shorter maturities and the latter the longer maturities.

### QUESTIONS AND SUGGESTIONS

1. What is an investable surplus, and where does it come from?
2. How does the amount of securities issued to secure new money, reported by the *Federal Reserve Bulletin*, compare with the total securities issued, reported by the *Chronicle*?
3. How widely distributed is the ownership of American corporations?
4. What are the characteristics of security buyers? What is included in the class of institutional buyers?
5. Who are trade buyers, and how do they operate?
6. What kinds of investment preferences do individuals have? How does the listing of securities influence purchases?
7. What classes of securities have been issued in this country?
8. What are the arguments against the direct sale of securities by the issuing corporation?
9. What are special security sales? Who are the purchasers? What has been the experience with the sale of securities to employees?
10. What special inducements have been given to employees to purchase stock?
11. What have been the results of employee stock ownership? What is the attitude of organized labor toward employee stock-purchase plans? Why?
12. Why is stock sometimes sold to consumers? To customers?
13. What are private sales of securities? How does the administration of the Securities Act encourage private sales?
14. How large is the volume of private sales?
15. Why have few railroad bond issues been sold at private sale?
16. What are the possible disadvantages to the issuing corporation in the private sale of bonds?
17. What are the possible disadvantages to the buyers? To other investors?
18. What are the limitations of private sales of securities?

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## SUBJECTS FOR INVESTIGATION

1. From the issues of the *Commercial and Financial Chronicle* near the end of last January or from other sources, determine the amount of securities issued during the preceding year and the purposes for which they were issued. Compare the totals with those of an earlier year, and account for any differences that you find.
2. From the annual reports of the Securities and Exchange Commission, find the amounts and kinds of exempted securities issued during a recent year.
3. From the same source find the amount of private sales of securities during the latest year available. How does this compare with the year previous to the one first studied?

## CHAPTER XXI

### INVESTMENT BANKING

**Meaning.**—The chief medium through which the savings of myriads of thrifty people have been made available to corporations seeking capital are the various types of investment banks. It is not easy to define an investment bank in a manner that distinguishes it from every other type of financial institution because it frequently partakes of the nature of these other types. On the one hand, many investment banking institutions include brokerage functions among their activities. Until the Federal government passed laws separating investment from commercial banking, these two types of activities were closely related. In a real sense, investment bankers may be called "securities middlemen." They are merchandisers whose stock in trade is stocks and bonds. They buy securities from issuing corporations and sell them at wholesale to security dealers and at retail to individual and institutional investors. Much of the new capital made available to American corporations reaches them through investment bankers.

**Early Conception of Distribution Function.**—Investment bankers and other security dealers have not always been in good repute. In an English case of a half century ago, Mr. Justice Kay paid his respects in the following terms:

Payment of what is called brokerage for placing shares is not really payment for work and labor. . . . The practice, so far as it exists, has grown up from the launching of bubble companies which would not be brought out without the aid of speculators who insist upon being paid a bonus or commission for their help. In the case of an enterprise which is favorably received by the public, not a penny need be spent in this way. It is only companies which are unsound, or at any rate unpopular, which resort to such devices.<sup>1</sup>

It would be interesting to know if the learned justice would follow the same reasoning today.

**Organization.**—The market organization set up for the disposition of securities parallels that of plans for distributing other merchandise. Wholesalers, jobbers, retailers, and traveling salesmen all play their part in this work. The wholesaler often purchases the entire issue of an existing corporation or supervises the distribution of other issues underwritten by him. The number of wholesale houses capable of handling large issues is small. Large retailers originate small issues as well as participate in the

<sup>1</sup> Cited in David Finne, "Capital Underwriting" (London, 1934), pp. 7-8.

distribution of issues originated by the wholesale houses. Branch houses and intermediate financial institutions serve as jobbers. Branches also retail securities, together with large numbers of correspondent banks and brokerage houses. Individuals also act as retailers, serving a limited clientele in a small area.

As indicated, the number of pure wholesalers is small. There are a few investment banking institutions that do not participate in retailing securities to investors. For the most part, however, wholesalers also participate in the retail part of their business. Likewise, there are combinations of retailers and brokers who deal both in listed or other securities which they try to sell, making for themselves a broker's commission. At the same time, they have for sale their own stock in trade on which they hope to make a profit. In like manner the functions of underwriter, participating distributor, dealer, and broker are confused in such manner that it is not easy to classify them into distinct groups.

**Limited Field.**—At the outset, it should be recognized that the investment banker has a limited field of operation. The more definite the separation of investment banking from mere brokerage, the more limited the field of activities becomes. Those who class themselves distinctly as investment bankers try to avoid handling speculative securities. Their primary interest is in the sale of securities of corporations in established industries with demonstrated earnings records. The statistical proof of this statement is contained in the following illustration. A study of the security issues originated by the eight largest private investment banking houses and the eight largest security affiliates of commercial banks for the years 1925 to 1932 leads to some interesting conclusions. Of the 2,526 issues originated by these 16 houses during the period studied, only 9.5 per cent were stock issues. Of these, 7.7 per cent were preferred stocks, and only 1.8 per cent were common stocks. The house that specialized in public utility issues enjoyed great success during the period studied, while the house that specialized in railroad issues had an unhappy record. The study disclosed no significant differences between the security affiliates as a group and the private banking houses as a group, either as to quality of offerings or degree of success attained.<sup>1</sup>

**Security Affiliates.**—In the decade of the 1920's, when commercial banks were developing into financial department stores, it was quite the fashion for the largest of them to absorb or to organize what would otherwise have been classified as an investment banking affiliate. The lure of profits to be made from the origination and distribution of security issues was too great to be ignored by many commercial banking institutions that found the sources of ordinary profits drying up. All went well with an active security

<sup>1</sup> Moore, F., *Security Affiliate versus Private Investment Banker—A Study in Security Originations*, *Harvard Business Review*, July, 1934, pp. 478-484.

market. The depression following the crash of 1929 raised serious questions about the relationship of commercial and investment banking. The result was the divorce of the two functions by legislative enactment in the Banking Act of 1933. The provisions of this act of interest here are as follows: (1) National banks in dealing in investment securities were restricted to the purchase of such securities, without recourse, solely upon the order and for the account of customers. (2) Banks that are members of the Federal Reserve System were required to divorce themselves from their investment affiliates within 1 year from the passage of the act. (3) Investment banks were prohibited from accepting deposits.

The language of the law is clear and inclusive. Its first paragraph reads in part as follows:

After one year from the date of the enactment of this Act, no member bank shall be affiliated in any manner described in Section 2b hereof with any corporation, association, business trust, or any other similar organization engaged principally in the issue, flotation, underwriting, public sale, or distribution at wholesale or retail or through participation of stocks, bonds, debentures, notes or other securities.

**Specialization.**—There is a high degree of specialization among investment banks. Those which specialize in the sale of bonds are known commonly as “bond houses.” In order to develop an aura of conservatism, they are careful to let it be known that they have nothing to do with the sale of stocks or even of speculative bonds. Many of them specialize in the selection of their clientele, dealing for the most part with institutional purchasers. Those who cater to the “individual” market, and particularly those who deal in stocks and second-grade bonds, do not have much opportunity to sell to institutional buyers. More often than not, they are thought of as brokers instead of investment bankers. There is also a tendency to specialize along industrial lines. Some are public utility specialists; others deal in real estate bonds; etc. And of course geographical specialization is indicated for all but those organized on a national scale. As is to be expected, even after recognizing the various types of investment bankers, ranging all the way from the most conservative to those who deal in speculative securities, there is still a vast area of security financing that is not touched by anyone classed as an investment banker.

**Internal Organization.**—The internal organization of the investment banking houses that are properly classified as such follows essentially the functions that they are expected to perform. The nature of the major functions, whether wholesaler or retailer, will of course determine the exact character of the organization of a particular banking institution. In the discussion that follows, we shall analyze the business of investment banking rather than the organization of any particular type of organization. The

logical development of functions starts with the purchase of security issues and follows through to their final disposition to the ultimate investor who is expected to hold his purchases for a considerable time. In other words, the investment banker is concerned with the final "digestion" of the securities. The intervening steps between purchase and final sale will be discussed in the following pages.

**Purchase of Securities.**—The nerve center of the investment banking business is in the purchase of securities. Here the task is twofold: to operate in such manner that both the issuing corporation and the purchaser of the securities will be so well pleased that they will want to place return orders for future business. If either is dissatisfied, a temporary profit to the banking house may be too small compensation for the efforts put forth. Like any other business, those engaged in the investment banking business hope to make permanent connections with both buyers and sellers of their products. The operations of the purchasing department lay the foundations for such relationships.

The securities that a banking house acquires for resale—its stock in trade—come either from originations or from participations. Participations result from friendly business relations with others engaged in the same business. If *A* contracts to sell securities for the *X* corporation, he expects to invite *B*, *C*, and *D*, other investment bankers, to participate in the distribution of the securities issued by *X*. In such case, *A* alone takes responsibility for the origination of the issue. *B*, *C*, and *D* are merely participants. Some banking houses never get beyond the participation stage. They depend upon others to originate the issues that they sell. Originations are secured from two sources. Personal relationships between the officers of the issuing corporation and the heads of the investment banking firm frequently result in business contracts. Some corporations look always to one banker to float their securities and some to another. As an alternative, there is the system of competitive bidding about which there has been considerable controversy.

**Competitive Bidding.**—When competitive bidding is used, the proposed security to be issued is offered for sale to the highest bidder. All interested parties that may wish to enter bids are given all the information upon which to make offers. The offer that is most advantageous to the issuing corporation is accepted. With respect to any particular issue of securities, it appears logical to expect that the corporation would wish to obtain the best terms possible from a reliable bidder. Competitive bidding in the sale of public utility securities has been required by law in Massachusetts for generations. Yet the subject has been a very controversial one. In general, governmental agents concerned with the regulation of security issues, such as the Interstate Commerce Commission and the Securities and Exchange Commission, have favored competitive bidding as being in the best interests



of both the issuing corporation and the purchasers of its securities. Some investment bankers have been equally vehement in their opposition to the practice.

The arguments used against competitive bidding are somewhat independent of the specific security issue under consideration. It is contended that it is essential for each corporation to have continuing relations with a specific banking house. Where such close relationships exist, even to the extent of giving the banking house representation on the board of directors of the issuing corporations, many types of services are rendered, some of which are not specifically compensated for. These include advice on dividend policies, mergers and purchase of assets of other companies, development of subsidiaries, budgeting, etc. In some of these matters, considerable time is required to study the facts before conclusions are reached. It is to be expected that an investment banker who is thoroughly acquainted with the business of the corporation through long association with it would be able to give better advice than one who has only casual acquaintance with its problems.

If the absence of competitive bidding results in a lower price to the corporation for a particular security issue, the bargain is still a good one for the corporation, it is contended, because of the services that have been rendered without compensation. It is also contended that where competitive bidding is not followed, the banking house takes a greater interest in protecting both the issuing corporation and the investor against errors, legal and other, in the issuance of securities. Whereas, where competitive bidding is followed, only the agents of the corporation pass upon vital questions concerning the security issue. It is also contended that open bidding invites participation of houses with lower standards in dealing with security purchasers. As a consequence, representations may be made which will result in loss to investors. As yet competitive bidding is largely confined to those situations where some governmental agency with authority requires it.

**Selective Function.**—The investment banker who values his reputation does not become the agent of every promoter who applies to him for assistance. As already indicated, the necessary qualifications of the promoter are imagination, optimism, and enthusiasm. Investment bankers cannot finance all projects presented to them. Many should not be given encouragement. The banker must investigate each applicant's case and determine for himself its safety and probable chances of success. He must supply the balance wheel of judgment which most promoters lack. In this manner, he performs a very useful function for the investing public by rejecting those securities of corporations which have less chance of success. Unfortunately for the large class of indiscriminating capitalists, large and small, the most speculative of ventures never pass in review before an investment banker. He gets no chance to investigate them. The security-buying public suffers

from the lack of exercise of the selective function, either by an investment banker or by a fair substitute for him. Although the investment banker does not guarantee the securities distributed by him, his reputation is staked on every issue. His judgment is not infallible. Yet a review by someone other than the promoter always adds protection to the investor.

**Selective Process.**—When a banking house is invited to consider the sponsorship of a security issue, it must first conduct a preliminary investigation to obtain answers to numerous questions upon whose answers its decision will be based. These include the kind of industry, the standing of the issuing corporation within the industry, the kind of securities to be offered, the size of the issue, the condition of the securities market at the time, etc. In case the answers to any of these questions are negative, the banking house may refuse to handle the issue, without prejudice to the corporation's ability to find another sponsor. Assuming, however, that the preliminary investigation produces results satisfactory to the banking house, a more thorough investigation follows.

Before a banking house approves an issue of securities or agrees either to buy or to undertake to sell them, it analyzes the business of the corporation, including the purposes for which the new securities are to be used. Engineers frequently check construction costs and pass upon the program generally. Accountants audit the financial reports of the corporation and conduct any pertinent special investigations. Lawyers report upon the validity of titles, patents, franchises, and all contracts of importance. Market analysts, production efficiency experts, and other technically trained investigators, who value their reputations as professional men, may be utilized to give the investment banker adequate bases for judgment about financing the proposed project. It must be remembered that these experts merely aid the banker; final decision rests with him.

The passage of the Securities Act of 1933 has resulted in definite modifications in the types of investigations conducted by the banking house. In the first place, the Securities Act places definite responsibility upon all who make representations concerning the issuing corporation and the securities that it proposes to issue. This has given cause for more careful investigations. Even then investment bankers have been hesitant to take too much personal responsibility for representations concerning the issuing corporation. The tendency has been to hire independent experts to analyze the position of the issuing corporation. The cost of these investigations is borne by the corporation.

**Pricing of Securities.**—After all the investigations have been made and the investment banker is satisfied that he can distribute the securities successfully, there remains the question of fixing the price. This is true whether the banker buys the securities outright or whether some other arrangement is agreed upon. The corporation wants as high a price as it

can get, whether the securities are sold by competitive bidding or otherwise. The banker wants to make a net profit. He knows what similar securities are selling for. While no two issues are alike, there is enough similarity to invite comparisons. The "spread" of the investment banker—the difference between the amount he pays the corporation and the price he expects to receive from the investing public—must be large enough to cover all expenses, to compensate for possible losses while the market is being stabilized, and still leave a profit for the banker. In the last analysis, of course, the price is fixed by the process of bargaining. Various factors combine to make this process favor the banker in one deal and the corporation in another. There are a variety of unknowns for both to consider in arriving at their decisions. In general, profit margins are small. Experience demonstrates that not all security flotations bring net profits to the investment banker.

According to the annual report of the Securities and Exchange Commission for the year ended June 30, 1945, the cost of floating registered securities is as follows:

Year ended June 30	Compensation as percentage of gross proceeds		
	Bonds	Preferred stock	Common stock
1939	2.0	6.4	16.9
1940	1.9	7.2	16.4
1941	1.8	4.1	14.4
1942	1.5	4.1	10.1
1943	1.7	3.6	9.7
1944	1.5	3.1	8.1
1945	1.3	3.1	9.3

The average cost for all issues was 3.7 per cent, divided between 3.2 per cent for commissions and discounts and 0.5 per cent for all other expenses, including registration costs.

**Underwriting Syndicates.**—Under modern conditions governing the investment banking business, the term "underwriting syndicate" means something different than was formerly the case. At least the application of the term is more narrowly confined than formerly. Before the days of security regulation, it was customary for a group of bankers—acting through the manager who alone made the contract with the issuing corporation—to ensure the sale of a specific security issue. In other words, this kind of syndicate contracted to purchase from the issuing corporation the remainder of any issue that had not been purchased by those to whom it was offered for sale. This kind of syndicate is still used in the case of privileged subscriptions, described in the next chapter. In effect, it is a form of insurance by

which the investment banker who makes the contract with the issuing corporation passes on a part of his risk to other investment bankers.

On the other hand, a group of bankers may agree to purchase an issue of securities in the hope of resale at a profit to investors. This form of agreement makes the underwriting syndicate synonymous with the purchase syndicate described below. In effect, the operations of the two kinds of underwriting syndicates may be essentially the same, so far as the participants other than the manager are concerned.

**Purchase Syndicate.**—When a corporation agrees with an investment banker upon the price of an issue of securities, the corporation frequently needs the money immediately. At least it has usually made commitments that will call for the use of the money at an early date. The investment banker is expected either to purchase the securities outright or to stand ready to turn over the cash to the corporation as needed by it. The amount of money needed for this purpose before the securities are actually sold may be larger than any one banker may care to invest in such a venture. He therefore calls upon other investment bankers, either to contribute a part of the necessary cash, or to assume the responsibility for supplying it to the corporation as needed. Such a group is known as a “purchase syndicate.” In case no carrying syndicate is used to carry the securities from the time they are purchased until they are finally disposed of, the purchase syndicate is expected to perform this function.

Where a purchase syndicate is used, it is to be expected that the members will have been kept informed of the progress of the negotiations for the securities. They may even be a party to the pricing arrangements, although usually the single banker, known as the “manager” of the syndicate, will conduct the negotiations. He does so knowing that he may depend upon the members of the syndicate yet to be organized to participate in it when the time comes. In specific cases, of course, there can be more than one manager. Then they would be known as comanagers. The members in turn usually expect to be permitted to participate in the distribution of the securities. The commission paid for purchasing and carrying the securities, in a sense the insurance premium, may be less than that paid for selling the securities. The insurance premium is due whether the members of the syndicate actually put up the money or only contract to do so if the corporation needs the money before the securities are sold.

**Nature of Commitment.**—Under the procedure currently followed in underwriting security issues, investment bankers try to protect themselves against the consequences of contingencies that may arise between the time they are approached to buy an issue of securities and the time when they can offer them in the market. Specifically, the 20-day waiting period established in the registration of the securities has raised doubts in a world where economic conditions sometimes change very rapidly. As a consequence,

absolutely firm commitments have become quite uncommon in recent years. Instead, the bankers agree with the issuing corporation upon the general terms of the contract but do not sign it until the securities are about to be offered in the market. Even then the contract frequently contains a "market out clause" which gives the underwriters the opportunity to cancel the contract before the money is paid to the corporation if, in their opinion, economic, market, or even political conditions have so changed that they doubt their success in marketing the issue. The purpose of such a clause is to relieve the underwriters from assuming unknown risks.

What is now known as a firm commitment covers those contracts which obligate the underwriters to purchase the entire issue at approximately the time of the public offering of the securities. These include the underwriting of privileged subscriptions. Other contracts call only for "best-effort" commitments. In such cases the underwriters—still called such in the Securities Act of 1933—act merely as selling agents for a fee but assume no risk for unsold securities. The issuing corporation must carry the risk of unsold securities. In a small number of cases, the contract combines firm and best-effort commitments. The underwriters assume obligations to purchase a part of the issue and agree to use their best efforts to dispose of the remainder. By far the largest proportion of contracts are of the firm-commitment type, modified as discussed in the preceding paragraph.

For the year ended June 30, 1945, the total amount of offered securities reported by the Securities and Exchange Commission was \$2,714,776,000. Of this amount, \$2,662,416,000 was offered by investment bankers, \$2,187,-844,000 on a purchase and resale basis, and \$474,572,000 on a best-effort basis. Only \$52,360,000 was offered by the issuers.

**Carrying Syndicate.**—If the time between the purchase of the securities and their ultimate sale is expected to be long or if the amount of money involved is unusually large, the members of the purchase syndicate may prefer to ask other financial institutions to share the risk with them. In such case a carrying syndicate is organized, a part of whose members may be members of the purchase syndicate. The members of the carrying syndicate may be asked to put up the money needed by the corporation or they may merely assume the risks involved, letting the manager of the carrying syndicate borrow the money needed, using the securities and the commitments of the members of the carrying syndicate as security for the loan.

**Distributive Function.**—When the investment banker has made his selections of the issues for which he is willing to assume some degree of responsibility, it then becomes his obligation to place the securities in the hands of the "ultimate consumer"—the investor. Whether the investment banker buys the issue outright or merely undertakes its sale, he is dependent upon the ultimate distribution of the securities for his profit. Regardless of the investment quality of the stocks or bonds to be sold, he does not wish

to keep his own capital tied up in them. More often than not, investors buy such securities, not because of their faith in the issuing corporation, but because of their confidence in the banking house that distributes them. Investors may know nothing of the issuing corporation and may be in no position to learn much of any consequence. They make their commitments on the standing of the investment banker.

**Banker or Broker.**—In this connection, a clear distinction should be made between the investment banker and the stockbroker. In effect, the latter says to the investor, "You tell me what you wish to buy or sell, and I will undertake to carry out the transaction for you. The judgment is yours, and I assume no responsibility for the consequences." The position of the investment banker, in relation to the investor, on the other hand, is quite different. In essence, the banker says, "I have investigated these securities and have faith in them. While I do not guarantee them, I recommend them to you and advise you to buy them. I recognize that my reputation is at stake and that I may lose your good will and your future business if you ever have cause to regret your purchase."

**Selling Syndicate.**—In spite of what has just been said about purchase and carrying syndicates, it is to the advantage of both the corporation and the investment banker to dispose of the whole issue of the securities quickly. For that purpose, selling syndicates are organized. The carrying syndicate contains a larger number of firms than the purchase syndicate. Yet both are relatively small in comparison with the selling syndicate. The latter may include several hundred investment bankers extensively distributed throughout the country. Many of those who participate in the actual sale of the securities are merely local retailers who are given but little opportunity to study the issue or indeed but little time to decide whether or not to participate in its distribution. Aside from some preliminary information of a tentative nature, their first formal communication may be an inquiry asking for a telegraphic response concerning the amount of the issue they wish to buy. They may either be offered an allotment of the securities or be asked to specify the amount they wish to buy. Their decisions are based upon general rather than specific considerations, such as their estimate of general market conditions, their opinion of the issuing corporation, and their desire to keep in the good graces of the manager of the syndicate.

It is understood that the average retailer has no facilities for making an adequate independent investigation of any particular security offering. He is necessarily dependent upon the advice of the syndicate manager. Nevertheless the reputation of the retailer is at stake when he resells the securities to his customer. Meantime he runs the risk that he may not be able to dispose of the amount for which he makes a commitment. In any event, he is just a salesman, using the arguments and appeals prepared for him by others.

Selling groups are more informal than selling syndicates. Less liability is assumed by their members. Those who participate merely undertake to sell such amounts of securities as they think their customers can absorb. They are expected to sell at the price fixed by the manager during the selling period. By this means, many small dealers are permitted to participate who could ill afford to take the risks imposed upon the members of the selling syndicate. Even where there is a syndicate involved, there will probably be many retailers whose participation is that of members of a selling group.

**Syndicate Profits.**—The gross profit to the investment banker who contracts to sell an issue of securities for a corporation varies with the character and size of the issue. The larger the issue, the smaller the percentage of gross profit. The more speculative the issue, the larger the percentage of gross profit. The "spread" for high-grade bonds may be surprisingly small. When syndicates are used, this spread is split several ways. The manager gets a managerial commission of perhaps one-eighth of the total; the remainder may be divided about equally between underwriting premiums and selling commissions. The spread for more speculative securities may be several times that for high-grade securities, depending upon a variety of combinations of different variables. One study found that for the years 1934 to 1937 average underwriting commissions for issues that included privileged subscriptions were as follows: bonds, 2.232 per cent; preferred stocks, 3.030 per cent; and common stocks, 8.833 per cent. For issues offered only to the public, the corresponding commissions were, respectively, 2.241, 3.576, and 14.396 per cent.<sup>1</sup> The distribution of these commissions between the underwriters and the selling group were as follows: for bonds, 55.8 and 44.2 per cent; for preferred stock, 51.7 and 48.3 per cent; and for common stocks, 60.4 and 39.6 per cent.<sup>2</sup>

The Interstate Commerce Commission reported that the spread for 14 issues sold under competitive bidding during the year ended June 30, 1944, ranged from 0.30 per cent for the Cleveland and Pittsburgh R.R. \$11,000,000 30-year general and refunding mortgage 3s to 1.55 per cent for the Gulf, Mobile and Ohio R.R. \$10,500,000 25-year first and refunding 3¾s. The experience of the Great Northern Ry. is shown in the following table:

Amount of issue	Rate of interest	Term in years	Number of bids	Spread
\$35,000,000	3½	15	2	0.64
30,000,000	3¾	25	4	1.10
35,000,000	3½	35	4	1.23

<sup>1</sup> Hoven, T. K., "Investment Banking under the Securities and Exchange Commission" (Ann Arbor, 1940), pp. 38-39.

<sup>2</sup> *Ibid.*, p. 62.

Syndicate profits vary with the stage of the business cycle. On the upswing, securities are usually disposed of quickly to the advantage of all concerned with their distribution. Syndicate operations that accompany definite downturns in security prices have been conspicuous for the losses sustained by their members. Like other optimists, syndicate members also overstay their markets and fail to dispose of their securities before it is too late to avoid large losses. The extent of losses suffered is not known, since accurate information about issues that are not marketed successfully is not available. One author states that both in number and in dollar volume over 20 per cent of the issues of bonds and preferred stocks are not completely sold at the original offering price.<sup>1</sup> This relatively high percentage recommends the use of underwriters in floating new securities.

Compensation to underwriters sometimes includes options to purchase common stock of the issuing corporation. Bankers who receive these options usually argue that this method of payment is in lieu of part of the cash compensation that they would otherwise receive rather than an addition to it. Most of the bankers' options are given in connection with small speculative issues, although larger and less speculative issues sometimes are accompanied by bankers' options too. About one-third of such options acquire considerable value.<sup>2</sup>

**Maintaining a Market.**—After an original issue of securities has once been distributed, it may take some time for it to become "digested"—to find a final resting place in the strongboxes of investors who expect to hold it more or less indefinitely. Until that time arrives, the market for the securities may be quite sensitive. Since some purchasers change their minds or purchase only for a quick turn, the floating supply may be relatively large soon after the issue is distributed. Regardless of the investment strength of the issue, selling pressure may be cumulative so long as the market continues sensitive. Whenever the supply at a given price exceeds the demand at that price, prices will recede. Recessions may cumulate unless the market is supported. The investment banker finds it to his interest to supply such support. He is under no legal obligation to buy back any securities offered for sale, but it may be good business policy for him to do so. The readiness of the market to absorb offerings at a price just below the original sale price usually tends to dry up the flow of securities offered for sale. This stiffening of the market overcomes its sensitivity and, under favorable conditions, makes purchasers satisfied with their investments.

**Practical Tests of Removal of Market Support.**—In a study of the effects of removing support from a pegged market, some interesting conclusions are evident. After the syndicate withdraws its maintenance of the market, the security prices fluctuate in response to usual market forces. Of 288 new

<sup>1</sup> *Ibid.*, p. 80.

<sup>2</sup> *Ibid.*, p. 122.



issues distributed in the years 1924 to 1932, 78.71 per cent broke their offering prices within 6 months from the time of issue; 69 per cent broke within 3 months, the average duration of a syndicate's operation.<sup>1</sup> Evidently in these cases the market was not too well supported. While the results of such studies are helpful and indicate tendencies, they leave important questions unanswered. In this case, it would be interesting to know how soon the issues broke not only the issuing price, but the level at which they were pegged by the supporting syndicate. This level is necessarily below the issuing price. Probably the investigators had no means of ascertaining the exact amounts. Then too a declining bond market would undoubtedly have an adverse effect upon the ability of any syndicate to "buck" a general trend in its efforts to sustain the price of a particular issue.

**Extent of Practice.**—Some evidence on the subject of the extent of the practice of maintaining the market for new security issues is found in the seventh annual report of the Securities and Exchange Commission. For the year ended June 30, 1941, out of a total of 335 registration statements filed under the Securities Act of 1933, 199, involving 227 security issues, indicated that stabilization operations would probably be undertaken. Actually in only 89 offerings, or about one-third of those indicated for stabilization, were operations undertaken. These involved bonds totaling \$799,500,000 and 12,886,782½ shares of stock with aggregate offering price of \$317,402,000.<sup>2</sup>

**Customer Sources.**—In seeking outlets for securities for sale, investment bankers of all types from local retailers to nationally organized wholesalers have a great advantage over all other security sales agencies in their lists of prospective customers. Each wholesaler knows the retail outlets and their sales capacities. Each retailer keeps a file of security buyers in his market area and knows their investment prejudices. In many cases, copies of current portfolios are available so that early maturities are known. These lists may be supplemented by good "prospects" among professional and business groups in the community and from lists of stockholders of well-known corporations. Such lists are subject to rapid change as the fortunes of investors rise or fall.

Even the investment prejudices of security buyers change so that a bond buyer today may wish instead to take a more speculative risk tomorrow. Investment bankers must be able to sense these changes in investor attitude and to cater to them if they hope to keep their trade. Once an investment banker can get his customers to seek advice, he is in a much better position to keep in touch with their buying habits. Since single sales of high-grade securities to small investors are not very profitable, it is always to the

<sup>1</sup>Steiner, W. H., and Oscar Losdon, *The Market Action of New Issues—A Test of Syndicate Price Pegging*, *Harvard Business Review*, April, 1934, pp. 339-344.

<sup>2</sup>Seventh Annual Report of the Securities and Exchange Commission, Washington, 1941, p. 141.

advantage of investment bankers to work for repeat sales wherever possible.

**Administrative Function.**—When the investment banker assumes responsibility for the distribution of an issue of stock or bonds, he assumes a moral obligation to protect his purchasers as much as possible. At arm's length, he may be of little use to them. As a member of the official family of the issuing corporation, he may be in a position to watch the interests of investors more closely. To accomplish this purpose, it may be necessary for him to secure representation on the corporation's board of directors or, at times, to take over direct control of its finances through the appointment of its treasurer. Continuing financial relations between a corporation and its banker may easily develop into "banker" control. Some corporations have titular heads who take their orders from their bankers. This development at once gives bankers unlimited opportunities for directing the flow of capital into American industries and places upon them the responsibility for rendering investments in corporate securities distributed by them as safe as possible.

**Trading Department.**—In order to maintain the market for the bonds they sell, large bond houses usually operate a trading department. It may be under the direction of the buying department or the selling division, or it may be independent of both. In addition to maintenance of the market for securities distributed by the selling division, the trading department disposes of the miscellaneous securities taken in exchange for securities distributed by the banker. Many of such securities are not sold outright but are exchanged for other securities. The advantages to the banker in taking such securities in exchange are many, including the following:

1. Unseasoned securities of the new issue are exchanged for seasoned securities more readily marketed.
2. Unlisted securities in small blocks frequently sell at a lower price than a large block could command from an institutional investor, for instance. By exchanging with a number of investors, larger blocks can be aggregated, with a corresponding increase in price to the banker.
3. Holders of bonds with early maturities are induced to turn these in, in exchange for parts of the new issue.
4. Investors temporarily short of cash are induced to buy larger blocks of the new issue, using securities already owned as down payment thereon.

The trading department also serves its clients by executing commission orders for securities purchased in the open market.

**Statistical Department.**—The statistical department performs various services, among which the most important are the following:

1. It aids the purchasing department by analyzing the business of the corporation wishing to sell its securities to the banker or through his organization. This may include an analysis of the industry represented and of the market possibilities of such securities at a given time.

2. The selling department relies upon the statistical department for the preparation of prospectuses and other advertising literature. The statistical department aids the selling department also by supplying the information necessary to anticipate, and to answer, the questions of prospective purchasers.

3. In assisting the trading department, it makes continuous studies of business conditions and of the values of specific securities and classes of securities. It keeps the banker's clients informed on topics of general investment interest. It advertises the trading and other departments through newsletters, releases, and circulars.

4. Clients of the banker are encouraged to seek advice from the statistical department. They are urged to send in their lists of holdings "for analysis." As a result of such study, the statistical department may advise switches from some of the securities now held into those distributed by the banker. Or, if the list is satisfactory at present, it will be kept on file to serve as the basis for future switches. If a continuous inventory of bond redemptions is kept and checked against investors' holdings on file, prospects for future sales may be found for the selling department. Large investors are given special services which may at times involve considerable time and effort.

5. Sometimes the statistical department, perhaps assisted by engineers, attorneys, etc., makes extensive investigations of individual corporations, such as a railroad, for example. The results of such a study may enable the banker to advise his clients of investment opportunities not familiar to the investment market generally. If the results of such studies are later published in booklet form for general distribution, the prestige and subsequently the clientele of the banking house may be increased thereby.

**Accounting Department.**—For the most part, the organization of the accounting department is for internal control only. It confines its attention to record keeping of the business transactions of the organization. If large enough, it may on occasion cooperate with the statistical department in investigations.

**Branches.**—What appears to be a definite trend in this country toward greater centralization of commercial banking control is paralleled by a similar tendency toward centralization of control of investment banking. Large investment houses have established branches in strategic centers. The more important of these have complete organizations based on the pattern of the departments discussed above. Smaller branches emphasize the sales work and depend upon the home office for other services.

Salesmen travel the territory contiguous to the home office and its branches, selling to commercial banks and other investors in localities within a radius of 200 miles or more from the banking office. Some banks within the territory served by these salesmen become correspondents of the home

office, or the nearest branch, and are given price advantages in security purchases not accorded to the average investor.

**Bond Departments.**—Bond departments of commercial banks should not be confused with investment bankers. The former are more often than not correspondents of the latter, at least in part. They serve two general purposes: (1) they supervise and conduct the security-investment operations of the bank of which they are a part; and (2) they advise and aid their customers in making security investments. They may even sell to their customers securities in their own portfolios or arrange for the purchase through brokers, or otherwise, of securities desired by their customers.

Bond departments of commercial banks seldom originate an issue of securities. Occasionally, perhaps, they sell a small bond or note issue for a local manufacturer or merchandiser. Likewise, they seldom participate directly in underwriting operations. They merely sell on commission, "subject to prior sale," whatever part of new issues they can distribute within their sales territory.

**Investment Bankers and Private Sales.**—In the preceding chapter, considerable attention was given to the subject of private sales of bonds by a corporation directly to one or a few institutional buyers, without making use of the machinery for the public distribution of securities. In some cases, such sales are made without the aid of investment bankers. In other instances, a corporation has sought the assistance of an investment banker to act as negotiator in interesting an insurance company in the purchase of its bonds. After all, the sale of securities is a specialized operation, surrounded with many legal and other technicalities. The investment banker is the expert in this field. Why should not the corporation engage his services to perform a technical service in conducting negotiations and in supervising the transaction? Presumably he is paid only a professional fee for such services, with all profits eliminated since he carries no financial risks. In other cases, finding his market for securities disappearing in the early 1930's, the investment banker took the initiative in interesting corporations in this new method of raising capital.

**Investment Banking and the Securities Act.**—As a partial offset to the loss of business through the direct sale of securities by the issuing corporations to insurance companies and other institutional investors, the operation of the Securities Act has undoubtedly resulted in reducing the competition of security salesmen who cannot be classed as investment bankers. For example, of the \$9,600,000,000 of securities registered with the Securities and Exchange Commission and offered for cash in the years January, 1934, to June, 1939, 96 per cent were offered through investment banking syndicates. Of those so offered, 38 firms managed 91 per cent of the total amount offered.

It is interesting to note that of the total amount offered by investment bankers 85 per cent was in bonds, 10 per cent was in preferred stock, and 5

per cent was in common stock. The staff of the commission made a study of the ratings of the bonds offered by the 38 leading investment banking houses for the period from Sept. 16, 1935, to June 30, 1939. These are the houses that are noted in the preceding paragraph. The ratings corresponded to Moody's classification of Aaa, first grade; Aa, second grade; A, third grade; Baa, fourth grade; etc. It should be noted that bonds classified in any of the four highest grades are eligible for bank investment. The percentage distribution of the results of the study is as follows:

Grade of bond	Firm selling most bonds	5 other leading New York City firms	14 other New York City firms
First.....	42.7	4.4	9.1
Second.....	36.5	37.2	14.5
Third.....	10.2	29.7	37.4
Fourth.....	8.4	26.9	32.3
Below fourth.....	2.2	1.8	6.7
Total.....	100.0	100.0	100.0

Grade of bond	18 firms outside New York City	Total
First.....	....	4.9
Second.....	30.8	28.9
Third.....	33.3	32.8
Fourth.....	29.6	29.1
Below fourth.....	6.3	4.3
Total.....	100.0	100.0

The distribution of the above bond issues by classes of industries and by grades is as follows:

Grade of bond	Manufacturing	Electric light and power, gas and water	Transportation and communication	Other
First.....	8.3	21.0	30.5	15.1
Second.....	7.8	42.1	42.5	31.1
Third.....	36.8	24.3	1.7	21.8
Fourth.....	38.5	9.7	24.5	29.0
Below fourth.....	8.6	2.9	0.8	3.0
Total.....	100.0	100.0	100.0	100.0

In comparing the industrial distribution of the above bonds, 26.4 per cent were issued by manufacturing companies; 50.9 per cent by electric light and power, gas, and water companies; 10.6 per cent by transportation and communication companies; and 12.1 per cent by all other companies.<sup>1</sup>

**Criticism of Investment Banking.**—In the literature of finance in recent years, there has appeared increasing criticism of the investment banker and of his relationship to business operations. The sources of this criticism are various. Much of it centers around the activities of those who encouraged the flotation of needless securities during the hectic decade of the 1920's. There is no doubt but that the thirst of investment bankers for profits frequently weighed heavier than the need of corporations for new capital. As a consequence, various corporations were financed and refinanced to the end that more securities could be fed into a very active market. We should not overlook the fact, however, that bankers were merely doing their best to meet the demands of greedy security buyers who also looked for a financing profit from an enhancement in security prices rather than an operating profit from the success of the corporations whose securities they owned.

"Banker" control has been interpreted to mean that the presence of a representative of an investment banking institution on the board of directors of a corporation necessarily means that the banking house controls the corporation. It has been assumed also that where such "control" exists the banker uses it primarily to gain profits for himself at the expense of others interested in the corporation. Seldom have the critics of bankers raised any question about the benefits that might be derived from having banking representation on corporation boards of directors.

Exorbitant profits and even worse have been charged against investment bankers. Instances of unduly large profits, accompanied perhaps by large bonuses or options to bankers, have been dramatized. Banker participation in what has later proved to be fraudulent promotions has been played up as if it was typical of all banker operations. There is no doubt but that, like most other people, bankers have exhibited bad judgment in many of their decisions. There is evidence also that among their number have been some who have practiced or abetted fraudulent activities. In their efforts to supply a demand for stocks and bonds, they have encouraged the flotation of securities that have not measured up to the standards advertised for banker-supported investments. Perhaps their bad associations have justified the flood of criticism that has been leveled against them in recent years.

### QUESTIONS AND SUGGESTIONS

1. Describe the organization of securities-distribution procedure.
2. What is an investment banking institution? Do investment bankers deal in all kinds of securities? Explain.

<sup>1</sup> This information is compiled from T.N.E.C. *Hearings*, Part 24, 1940, *passim*.

3. What are security affiliates? What is their present status?
4. What kinds of specialization are practiced by investment bankers?
5. What is the initial function of investment bankers? Differentiate between originations and participations.
6. Give the arguments for and against competitive bidding.
7. What is the selective function? How is it performed? How has the Securities Act influenced this function?
8. How is the price of a security issue fixed?
9. What is an underwriting syndicate? A purchase syndicate?
10. What kinds of commitments do investment bankers make to issuing corporations?
11. What is the distributive function of investment bankers?
12. What is meant by the spread in bond prices? Who gets it? What is the amount of the spread in typical cases?
13. What is meant by maintaining a market? What are its purposes? How is it accomplished?
14. Where do investment bankers find customers?
15. What is the administrative function of investment bankers?
16. What is the purpose of the trading department?
17. What contributions are made by the statistical department?
18. What is the attitude of investment bankers toward the private sale of securities?
19. How has the administration of the Securities Act affected the business of investment bankers?
20. What criticisms have been made of investment bankers?

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#### SUBJECTS FOR INVESTIGATION

1. Compare two recent prospectuses to find how many investment bankers whose names appear on one appear also on the other.
2. From the statements in these prospectuses does it appear that the bankers concerned expect to maintain the market for the securities they are issuing? What statements do you rely upon for your answer?
3. What advisers and experts have contributed to the above prospectuses?

## CHAPTER XXII

### PRIVILEGED SUBSCRIPTIONS

**Meaning.**—A “privileged subscription” applies to the purchase of stock issued by a corporation to existing shareholders. The term “privilege” implies two things: (1) that only those who are already stockholders are permitted to buy the stock of the new issue, and (2) that special inducements are offered by the corporation to ensure the sale of the new issue. Corporate stockholders are presumed to have an interest in the success of the enterprise with which they are associated. The quality of this interest is selfish, however, and not philanthropic. For that reason, even satisfied stockholders are not likely to subscribe for additional stock, unless they can realize an advantage to themselves. The form of the inducement that is most commonly associated with a privileged subscription is the right to buy the stock at a lower price than is asked in the open market. There is an assumption that this price is also lower than would be asked of others than stockholders if the stock is sold by the corporation. This assumption is more academic than real, however. If present stockholders are unwilling to pay the price asked of them, it is not likely that others would be anxious to pay a higher price. Underwritten stock issues not absorbed by present stockholders usually brings a lower net price to the corporation, by the time underwriting commissions are deducted.

Privileged subscriptions are usually associated with business success. The proceeds are usually needed for the purpose of meeting the costs of an expansion program or for redeeming outstanding bonds.<sup>1</sup> They are usually offered during prosperity stages of business cycles. On the one hand, there is a theory that the corporation should share its success with its present stockholders by giving them the first opportunity to buy the new stock offered. Incidentally, since the money to be raised from the sale of the stock is definitely needed to meet the costs of an expansion program, the corporation must make sure that its offer of new stock will be accepted. This fact helps to account for the offer at a price less than current market appraisal of the stock. On the other hand, another theory gives the stock-

<sup>1</sup> In a study of 296 privileged subscriptions covering the years from 1930 to 1938 (which admittedly was not a particularly good time to study this subject) Davis found that the alleged reasons for issuing these subscriptions were as follows: expansion and capital additions—61 per cent of the cases studied; retirement of bonds, bank loans, and preferred stock—25 per cent; and general corporate purposes—14 per cent. Davis, J. H., *Privileged Subscriptions*, unpublished M.B.A. thesis, Ohio State University, 1940.



holder the right to subscribe to any new stock that the corporation may wish to sell.

While the right to subscribe to new stock is granted to stockholders on a prorata basis, stockholders are sometimes invited to bid for shares not absorbed by other stockholders. In 1936, stockholders of the Franklin Rayon Corp. were offered rights to subscribe for new stock. Each stockholder was permitted to subscribe for as many shares as he desired. The total issue of new common stock amounted to 10,000 shares. It was announced that, in case of oversubscription, allotments would be made in proportion to subscriptions. In offering new stock at \$20 per share in the ratio of one new share for each five held, the Harshaw Chemical Co. permitted its shareholders to apply for additional shares at \$20 each. The right to subscribe for the regularly allotted shares in the ratio of one to five was transferable, while the privilege of subscribing for extra shares was not.

**Preemptive Rights.**—At common law, stockholders have the right to subscribe pro rata for new stock issued by the corporation. The justification for this rule is that only by subscribing for new stock in proportion to the amount already held can a stockholder retain his voting position and his share in the surplus where the new stock is offered below the current value of outstanding stock. For example, suppose a corporation with 1,000 shares of \$100 par stock has a surplus of \$50,000. If A owns 100 shares, he has a claim against \$5,000 of the surplus and the right to vote 10 per cent of the voting stock. If the corporation issued 1,000 new shares of stock at \$100 each and if A purchased none of them, he would then have a right to vote only 5 per cent of the resulting stock and his share of the surplus would be reduced to \$2,500. This example assumes that the usual practice is followed of offering a privileged subscription at a price considerably lower than the market price of the stock. In order to maintain the preemptive rights of the stockholders, it is not necessary to offer stock to them at less than could be obtained from outsiders.

Preemptive rights do not apply to the following cases of stock issue: In the original issue of stock, there are no rights to control established and presumably there is no surplus. Hence the stock may be offered to any one interested in its purchase. Just what constitutes an "original" issue may be open to dispute. If, for instance, 50,000 shares were originally offered but only 30,000 sold at the time and the remainder was not sold for a couple of years, questions might be raised whether the second installment did not constitute a new issue. Treasury stock is not ordinarily subject to preemptive rights. Such stock is considered to be an asset of the corporation, to be disposed of to such buyers as the corporation may see fit to select. Stock exchanged for property need not first be offered to the stockholders. The law recognizes the right of the corporate management to make an exchange of stock for property without first consulting the stockholders.

Exceptions occur where the value of the property to be acquired might be large in proportion to that already owned. In this case the stockholders might need to approve even the acquisition, thereby impliedly approving the exchange of stock for the property.

Since the theory of preemptive rights is to give the stockholders the right to maintain their voting control and to protect their share in the surplus, only such stock as has a claim against the surplus and a right to vote possesses preemptive rights. As a consequence, preferred stock issues that are non-voting and nonparticipating are not expected to possess preemptive rights. However, the practical application of the financial principles involved in preemptive rights is much more significant for corporation finance than any legal discussion of exceptions. Once a corporation passes its initial trial period, which is financed by its original issue of stock, most of its successive sales of common stock take place by means of privileged subscriptions. For a great many corporations, all future financing comes either from an investment of earnings or from the sale of additional stock to present stockholders.

**Waiver of Rights.**—Preemptive rights are established by common law, and they may be taken away by statute law. The corporation code of Delaware provides that no preemptive right exists unless it is specifically granted by the corporation's charter. Corporate charters sometimes contain clauses that take away the common-law preemptive rights. Neither the common nor the preferred stock of the American Radiator and Standard Sanitary Corp. has any right to purchase or to subscribe for any part of any new or additional issues of stock or of securities convertible into stock, whether authorized or not, and whether sold for cash or other consideration. In spite of the provision in the Delaware law noted above, the charter of the Manhattan Dearborn Corp. of Delaware includes the following clause: "No holder of any stock of this corporation shall be entitled as of right to purchase or subscribe for any part of any unissued stock of this corporation or for additional stock . . . to be issued." In the absence of any statutory or charter provision providing for a waiver of preemptive rights, the stockholders may vote to deprive themselves of this privilege. When the corporation wishes to sell blocks of stock to employees or to customers, it first secures a specific waiver of preemptive rights from its stockholders.

**Statutory Tendencies.**—As already indicated, preemptive rights stem from the common law. Although much of American common law has its origin in English practices, England and Canada do not appear to grant preemptive rights as a matter of common law. The English Companies Act carries a provision that requires corporate directors to offer new stock pro rata to existing stockholders. In this country, the statutory law appears to be moving in the direction of removing preemptive rights. While the statutes of 30 states are still silent on the question, the others have dealt with the subject in some manner. The laws of nine states provide that stockholders

shall have preemptive rights, unless the articles of incorporation provide otherwise. Five states declare that no preemptive rights exist unless the articles contain a grant of such rights. And four states place limitations upon the use of such rights by the shareholders.

**Convertible Bonds and Preemptive Rights.**—The use of convertible bond issues complicates preemptive rights. In the first place, convertible bonds may not be issued in such manner as to evade the preemptive rights of existing stockholders. Unless the rights of existing stockholders are waived, they must be given first chance to purchase convertible bonds. Otherwise, through conversion, their voting rights and ownership equities might be diluted. In the second place, the holders of convertible bonds may find their rights diluted through the issue of new stock, subsequent to their purchase of convertible bonds. Should new stock be issued at less than the selling price of existing stock, as would usually be the case, the conversion rights of holders of convertible bonds would suffer a decline in value. However, such bondholders have no recourse except to convert their bonds in time to secure preemptive rights to purchase their share of the new stock. As bondholders, they would have, ordinarily, no preemptive rights in new stock issues.

Even in refunding operations, the preemptive rights of stockholders may not be ignored. For example, in 1936 the Great Northern Railway Co. refunded its general mortgage 7 per cent series A bonds, amounting to \$100,766,000, at maturity, offering in exchange general mortgage 4 per cent convertible series G and H bonds, to the extent that they were not subscribed for by stockholders. The latter, however, purchased all but \$5,285,000 of the new bonds. Although this issue was underwritten by the Reconstruction Finance Corporation, none of the bonds were left to be absorbed by the underwriter, since the bondholders took what was not purchased by the stockholders. Taking advantage of lower interest rates in 1936, the National Dairy Products Corp. refunded its 5½ per cent debentures with 3¾ per cent convertible debentures, offering the new issue first to its stockholders. After the stockholders took 57 per cent of the new issue, the holders of the old debentures took the remaining 43 per cent. Stockholders are not always so willing to subscribe for convertible bond issues. Nevertheless, the corporation must either make the original offer to its stockholders or ask them to waive their preemptive rights. For example, in 1937, the Bethlehem Steel Corp. issued \$48,000,000 in convertible debentures. To meet its contractual obligations, it offered these debentures first to its common stockholders, in the ratio of \$15 in debentures for each share of common stock held. The stockholders subscribed for only \$1,996,700 of the debentures.

Stock purchase warrants are handled in the same manner as conversion rights in bonds. The stockholders may not have their preemptive rights

defeated by the distribution of stock purchase warrants, without their consent. Similarly, the holders of warrants have no preemptive right to purchase portions of new stock issues, unless and until they become stockholders through the exercise of their rights to use such warrants.

**Rights to Bonds and Preferred Stock.**—Preemptive rights apply only to stock that has voting rights and a claim against the surplus of the corporation and to securities convertible into such stock. Nevertheless, the corporation may think that its best source of new capital is its present stockholders, even though they may not be willing to buy new common stock. Regardless of the absence of preemptive rights, the corporation may see fit to offer either bonds or preferred stock to its present stockholders. The price fixed on such securities must be capable of attracting the favorable attention of the stockholders. It may be higher than the corporation could have obtained from investment bankers. On the other hand, the anxiety of the management to fix a price that will be sure of acceptance may result in a lower price or a higher yield than the circumstances warrant. In making offers of this kind, others than the holders of common stock may be included. When the Public Service Corp. of New Jersey offered a new issue of cumulative preferred stock to its stockholders, it made no distinction between holders of common and preferred stock. Each was given the right to buy one new share for each 20 shares held.

**Nature of Privilege.**—There is likely to be considerable misunderstanding about the exact nature of the exercise of a preemptive right. The right of stockholders to subscribe pro rata to a new issue of stock at less than the market price of outstanding stock of the same class is frequently called a "privileged subscription." This term is misleading since it implies that the stockholder has a choice that he may take or leave without disadvantage to himself. A better term would be "obligatory" subscription. A passive attitude on the part of a stockholder will work to his disadvantage. Even if he takes advantage of the so-called privilege, he is merely maintaining his position. In no case can he gain an advantage directly from the purchase of his prorata share of the new stock.

Perhaps an example will make clear just how the so-called privilege becomes an obligation. In the following illustration, book values are assumed to represent the true values of the corporation's stock. Suppose that the balance sheet of a given corporation reads as follows:

Assets		Equities	
Fixed assets . . . . .	\$200,000	Stock (1,000 shares) . . . . .	\$100,000
		Surplus . . . . .	100,000
Total . . . . .	\$200,000	Total . . . . .	\$200,000

It is evident that each share of stock has a claim against \$100 of the stock account and an additional \$100 of the surplus. Suppose stock is offered to the present holders, share for share, at \$100. After giving effect to the new subscription, the balance sheet will read as follows:

Assets		Equities	
Fixed assets.....	\$200,000	Stock (2,000 shares) .....	\$200,000
Cash.....	100,000	Surplus .....	100,000
Total.....	\$300,000	Total .....	\$300,000

Each share of stock now has a claim represented by \$100 in the stock account but only \$50 in the surplus. If Jones owned 100 shares of the original stock and dropped his privilege to subscribe for an additional 100 shares of stock into the wastebasket, he dropped with it one-half of his voting rights and a claim of \$5,000 against the surplus account. By assuming a passive attitude, he is the loser of both equity and control. If he accepts the so-called "privilege" and subscribes for his allotment of 100 shares, he retains his full voting rights and keeps his share in the surplus. He has gained in neither equity nor voting rights. He is therefore obligated to exercise his preemptive right or forfeit a part of both control and ownership equity.

In other ways also the so-called privilege may become instead an obligation. For example, during the decade of the 1930's, corporations that had normally been quite successful and had paid satisfactory dividends to their stockholders found that their financial situations seriously handicapped their future plans. They were not only unable to continue dividend payments, but lack of liquid capital paralyzed their current operations and their desires for future expansion. Their stockholders still had confidence in their capacity for recovery. With normal sources of new funds temporarily closed, they appealed to their stockholders as their only source of new capital to rehabilitate their plants. Naturally, such appeals could produce satisfactory results only where the stockholders had retained their faith in the future of their corporations.

**Success of Privileged Subscription.**—A combination of favorable conditions is necessary to ensure the success of any privileged subscription offer. Among them the most important are the following:

1. There must be considerable spread between the current price of the stock and the price asked by the corporation. The old stock must sell enough higher than the new to make stockholders think they can purchase stock from their corporation cheaper than they can purchase it in the open

market. In May, 1929, common stockholders of the U.S. Steel Corp. were given the right to subscribe at \$140 per share for one share to each seven shares held. Stockholders subscribed for 99.3 per cent of the offering. Prices of the stock for 1929 ranged from a low of \$150 to a high of \$261¾ per share. In 1937, Taylor-Colquitt Co. offered to its common stockholders the right to buy 14,200 shares at the ratio of one new share for each five held. All but 14 shares were subscribed for. The owners of 70 outstanding shares could not be located. Stock-market breaks are disastrous to rights. In 1929, for example, numerous corporations declared rights just before the market break. Before the rights expired, the market prices of the stocks had fallen below the price at which the stock was offered by the corporation. The result was to make the rights worthless, since no one would pay the corporation more than was asked for stock in the open market. The possibility of some decline in the market price of the stock during the time the privileged subscription is effective is another reason why there should be a considerable spread between the current price of the stock and the price asked by the corporation. Of course if a definite break in the market price interferes with the plan of disposing of the new stock, the corporation has no alternative but to cancel the privileged subscription.

2. Success of privileged subscriptions is determined, in part, by the extent of distribution of the old stock. If the stock is closely held, each stockholder would be asked to take a large proportion of the new issue. Whatever he might think of his present investment, he might not be in a position to subscribe for a large amount of new stock. Wider distribution of stock will ensure greater success of the privileged subscription.

3. Privileged subscriptions are most successful when the amount of new stock to be offered bears only a reasonable relation to the amount outstanding. An offer of one share of new stock for each seven shares held would be more likely to succeed than an offer to subscribe on a one-to-one basis. It is not unusual for stockholders to neglect to take advantage of valuable rights to subscribe for additional stock. Probably this tendency is more marked where the stock is widely held and where the value of rights held by individual stockholders may not be great. Some stockholders do not understand the procedure for taking advantage of privileged subscriptions and lose because of their lack of acquaintance with financial machinery. On the other hand, since many small stockholders receive the right to buy only a fraction of a share of new stock, they tend to provide a market for those who wish to sell. Frequently in notifying the stockholders of their rights to buy new stock, the issuing corporation explains the means of buying additional rights and of disposing of those that may be for sale.

4. Present stockholders must feel optimistic about their present investment before they will risk more capital in the stock of the same corporation. They must feel that the new money will be wisely used for expansion and

not to make up past losses. Also, the timing of privileged subscriptions is important. Few stockholders would wish to risk new money at a time of depression, when the whole industrial structure seems unstable. Willingness to make additional commitments reflect not only confidence in the issuing corporation, but faith in general market conditions. A specific corporation might be ever so successful, and yet its privileged subscription might not receive a hearty response from its stockholders because of their fear of the "general outlook" for business.

**Rights.**—The privilege of subscribing to a new issue of stock offered by a corporation to its stockholders is called a "right." After the preliminaries of any such issue have been cared for, each stockholder receives a formal certificate known as a "warrant" and resembling a stock certificate. It states the exact number of shares to which the stockholder is entitled to subscribe, the price to be paid, and the time limit within which the right must be exercised. Separate warrants are issued for fractions of shares. When a stockholder wishes to take advantage of his right to buy additional stock, he returns the warrant to the corporation or its agent, together with payment for the stock. In case payments are to be made in installments, the accompanying check might cover only the first installment. It is not uncommon for corporations to encourage payment for the stock on the installment plan. By this means they hope to sell more stock. Some interest may be allowed on installment payments, since dividends are payable only after the stock has been issued after being fully paid for. When Montgomery Ward and Co., Inc., offered a privileged subscription in 1946, the covering letter to the stockholders provided that, at the stockholder's election, he could pay 50 per cent with the subscription, 25 per cent in 3 months, and 25 per cent in 6 months.

A distinction is made between "New York" rights and "Philadelphia" rights that is sometimes confusing to the average stockholder. A Philadelphia right is the right to subscribe to one full share of stock. If new stock were being offered at the ratio of 1 for 10, the owner of 10 shares at present would receive one Philadelphia right. A New York right, on the other hand, defines the privilege that is given for each share of stock. For example, if new stock were offered at the ratio of 1 for 10 shares held, the owner of 10 shares would receive 10 New York rights. The use of New York rights is more common, since it more accurately describes the situation in which buyers and sellers of rights find themselves. Prices of New York rights are more easily arrived at than prices of Philadelphia rights. This is particularly useful when it is necessary to buy or sell rights to fractional shares of stock.

**Value of Rights.**—Rights are issued under carefully defined conditions and expire on a specified date. Previous to that time, a stockholder may sell his stock and his rights, may sell his stock and retain his rights, or retain

his stock and sell his rights. Since valuable rights can be assigned definite prices, they are subject to purchase and sale in the same market that fixes the price of the stock to which they are attached. The theoretical value of the right is determined at any time by the following process: From the market price of the old stock is subtracted the price at which new stock is offered by the corporation. This difference, divided by the number of shares carrying the right to buy one new share plus the new share purchased, will represent the value of the right. For example, if the old stock is selling at \$150 per share, if one new share is to be offered for each four shares outstanding, and if the new stock is to be offered at \$100, the value of the right would be

$$\frac{\$150 - \$100}{4 + 1} = \$10.$$

Therefore each share of stock owned would carry a right worth \$10 under the conditions mentioned. This can be illustrated by reference to the balance sheet. Suppose the corporation's balance sheet before the rights were issued represented market value and read as follows:

Assets		Equities	
Assets.....	\$150,000	Stock (1,000 shares) .....	\$100,000
		Surplus .....	50,000
Total .....	\$150,000	Total .....	\$150,000

Each share of stock would have a claim to \$50 of the surplus. After giving effect to rights as outlined, the balance sheet would read:

Assets		Equities	
Assets.....	\$175,000	Stock (1,250 shares) .....	\$125,000
		Surplus .....	50,000
Total .....	\$175,000	Total .....	\$175,000

Each share of stock would have a claim to only \$40 of the surplus.

In other words, the issue of the new stock dilutes the value of each old share by \$10. This dilution represents the value of the right. It also represents the cost of the right to the stockholder. Hence the stockholder who takes advantage of his right pays full value for it and just maintains his ownership position in the corporation. If he fails to take advantage of the right, he pays for it just the same and sacrifices its value by failing to redeem its price.

**Market Prices.**—Market prices of rights do not always coincide with the theoretical value as defined above. Several reasons account for possible



differences. In the first place, there is a tendency for some stocks to increase in price upon the announcement of a privileged subscription. Such announcements are almost always made in periods of general upswings in security prices. Since stockholders are not always kept currently informed about the progress and the prospects of their corporations, the announcement of a privileged subscription may be accepted by those interested in security purchasers to mean that the corporation is doing unusually well and has even better prospects ahead. As a consequence, the tendency may be to reflect the announcement of a privileged subscription in a greater demand for the stock. On the other hand, an increase in the supply of the stock would naturally cause some decline in its price unless an immediate increase in demand developed.

Available evidence seems to support the contention of many brokers that rights sell at their highest price immediately after they come into the market. The statistical evidence on this subject is not conclusive and deals only with averages. Individual corporations might show different results. Also specific years might show general results out of line with broad averages. Many factors influence the price of rights. Among them is the number of new shares that are offered in proportion to the outstanding stock. It is to be expected that an offering of 1 for 1 would show a different market response than an offering of 1 for 10. Many stockholders may withhold decisions on what action to take until near the end of the period when the rights are effective. The nature of their decision would influence materially the price of the rights. General business conditions and changes in the general level of security prices during the life of the rights will be reflected in their price. Rights, as well as the stock prices, are subject to speculative influences and manipulation.

In the issuance of rights by corporations whose stock prices fluctuate violently, it is to be expected that market prices of rights will fluctuate widely also. For example, in 1929 the market price of the common stock of J. I. Case Co. reached a high of \$467 before the break in the stock market. After the break it dropped to \$130 before the end of the year. But, before the break, rights to subscribe to new stock at \$150 per share at the ratio of one for two were given to common stockholders. Within the 30-day period during which these rights could be exercised, the price of the rights fluctuated from a low of \$2½ to a high of \$81.

Admittedly, the above illustration covers an unusual case. Seldom would the price of rights rise as high as that shown in the preceding paragraph. Perhaps more commonly the prices of rights follow patterns like those shown in the two tables on page 403. In each of the illustrations used prices of successive issues of rights are recorded. The fact that both of the companies are in the public utility field helps to account for the relative stability of the prices of the rights. Even here the range of prices is quite wide.

The record of rights of the Peoples Gas Light and Coke Co. is as follows:

Rights expired	Ratio of offering	Sub- scription price	Prices of rights		Closing prices ex date	
			High	Low	Stock	Right
July 17, 1925.....	1 to 10	\$100	\$ 2	\$ 1½	\$119	\$ 1¾
Nov. 15, 1926.....	1 to 10	100	2½	2	122	2½
Nov. 3, 1927.....	1 to 10	100	6	4½	153¾	5¾
Nov. 5, 1928.....	1 to 10	100	9½	7¾	188½	8½
Jan. 15, 1930.....	1 to 10	100	15	11	*	13½
Jan. 15, 1931.....	1 to 10	100	12½	8¾	198	9¾
Jan. 15, 1932.....	1 to 100	100	4¾	¾	121	2

\* Bid 238—ask 260—no sales.

In offering to common stockholders right to buy additional common stock, the following record of the Pacific Gas and Electric Co. is of interest:

Expiration of rights	Offering price	Ratio	Price of rights	
			High	Low
Mar. 31, 1926.....	\$100	1 to 10	2½	1½
Mar. 1, 1927.....	25	1 to 10	¾	½
Mar. 3, 1928.....	25	1 to 10	2¾	1¾
Mar. 20, 1929.....	25	1 to 10	3½	2½
Oct. 21, 1929.....	25	1 to 10	6½	3¼
Oct. 21, 1929.....	55	1 to 10	3¼	¼
Mar. 11, 1931.....	25	1 to 10	3	3

Where stock is not listed and therefore where there is no established price even for outstanding shares, it is not so easy to determine either the theoretical value or the market price of rights. Nevertheless, estimates of values are arrived at by those interested in transactions in the rights. In the same manner, even with listed securities, suppose the corporation should offer its present shareholders the right to subscribe to an issue of preferred stock or a bond issue that is new for the corporation. In other words, assume that there is not even an over-the-counter price to consider because there have been no units of the new issue existing heretofore. Yet it will be offered in terms of a fixed ratio to the number of shares of stock held. Again estimates will be necessary to determine the value of rights. This situation is further complicated if the appeal of the bond or preferred-stock issue is its right of conversion into common stock at prices higher than those prevailing at the time of issue.

**Offering Prices.**—Presumably, corporations offer privileged subscriptions only when they have need for the funds to be raised thereby. Presumably also, the major objective of such offers is the raising of new capital. It would follow, therefore, that the price to be asked for the new stock would be fixed at that point which will produce the greatest amount of new capital and which, at the same time, will induce the acceptance of the offer by the greatest number of existing stockholders. If the price is fixed too high, it may not induce the purchase of the required amount of the stock, thus handicapping the plans of the corporation. If it is fixed too low, it may work to the disadvantage of those stockholders who do not take advantage of their rights. The obligatory nature of a so-called privileged subscription has already been pointed out. Those stockholders who do not take advantage of the right in some manner lose a part of their equity in the surplus.

However, for three reasons prices are seldom so nicely adjusted as the above reasoning suggests. In the first place, corporate managements have no exact means of knowing just what price will produce the most satisfactory results for the corporation and the stockholders. As a consequence, new stock prices are fixed more or less arbitrarily with a tendency to lean to the safe side. In the second place, general market fluctuations beyond the control of the management may upset its plans completely. What appeared to be an ample spread at the time the privileged subscription was planned may become entirely too small if the market breaks sharply before the new stock is subscribed for. In the third place, the corporation management may have in mind other objectives than the obtaining of new capital from its stockholders. For various reasons, it may wish to reduce the value of its stock without using any of the other means available to it. It may accomplish this while it is obtaining new capital. It may wish to encourage speculation by selling the new stock at a price lower than is necessary to secure the needed new capital. It may even wish to fortify itself against a too drastic decline in its stock prices if and when a break in the market occurs.

**Stock and Right Quotations.**—Where stock is listed on a stock exchange, the rights attached to it will normally be quoted on the same exchange. With respect to price quotations, there are three dates that are important to keep in mind.

1. The corporation makes an announcement of the offering of the privileged subscription. In this announcement, the corporation will fix a date on which stockholders of record will be given the rights to subscribe to the new stock. Between the date on which the rights are announced and the date on which warrants are to be issued, all stock that is transferred on the books of the corporation carries with it the privilege of sharing in the rights. This period is known as the "rights-on" period. In effect, the price of the stock quotations during this period covers both stock and rights.

stock. Perhaps the sale of his rights would best suit his purposes. If so he should recognize the consequences of his decision. There are several reasons why a particular stockholder might prefer to sell his rights rather than buy more stock.

**Profits from Privileged Subscriptions.**—As already pointed out, if speculation is eliminated, there can be no profits from privileged subscriptions. Rights cost all they are worth, whether they are disposed of or not. If not used in some manner, they result in losses to the stockholders who neglect to use them. The so-called “profit” from the sale of rights is merely a return to the stockholder of a part of his capital investment. The only profit attaching to privileged subscriptions results from successful speculation in rights. However, most stockholders who are not in-and-out speculators are not greatly interested in profits from the sale of rights, or in price fluctuations during the period when the rights are effective. They would like to know the longer term effect of the issuance of rights upon the prices of their stock. There is a general impression that declines in stock prices due to dilutions of the surplus will soon be recovered and that future prices will be just as high as past prices. If future earnings are maintained, due to the successful expansion of operations from the investment of the proceeds of the sale of the new stock, perhaps stock prices may gradually recover. It is hardly proper to assume that all declines in prices due to the use of privileged subscriptions will be automatically recovered in the future operations of the corporation.

Nevertheless, under the circumstances that are usually present when privileged subscriptions are used, most of them are quite successful. Repeat orders of satisfied customers are always fairly easy to obtain. When a stockholder thinks well of his investment, he is usually interested in buying more stock from the same corporation, if his finances permit, particularly at prices below the market. Indeed, old stockholders are good prospects for other classes of securities not carrying the preemptive right. Only the uninformed stockholder disregards his rights to subscribe to new stock. There are always some who do not understand the warrant issued to them and who drop it into the wastebasket with proxies and other literature of the sort. Some, through neglect, fail to act before the rights expire. As an example of a corporation that has been quite successful in disposing of new stocks to its stockholders, the experience of the Detroit Edison Co. is cited on page 407.

**Disposition of Unsubscribed Stock.**—Stockholders are not forced to buy new stock. They are merely offered the opportunity to buy under favorable conditions. If for any reason the new stock is not all subscribed for by the holders of outstanding stock, the board of directors may dispose of the remainder in the open market. The price of stock that is not underwritten may be higher than that asked of stockholders, determined by the amount of stock not absorbed by stockholders. Small proportions present oppor-

tunities to those who would like to acquire more than their preemptive rights entitle them to subscribe for. Large proportions present problems of disposition of a "sour" stock issue.

**Underwriting Privileged Subscriptions.**—The proceeds from privileged subscriptions are frequently spent for expansion before they are received. At least the corporation has often made commitments before the actual cash is in hand. Although, at the time the new financing is planned, favorable results are anticipated, many things may happen before the stock is actually sold to upset all plans and produce failure. Irrespective of the business pros-

DETROIT EDISON CO. SALES OF NEW ISSUES

Year	Percentage of holding offered	Price	Total new issue*	Sold to		
				Stock-holders*	Under-writers*	General public*
1911	25	\$100	\$ 1,500	\$ 1,497	.....	\$ 2
1913	30	100	3,150	3,073	....	76
1916	15	100	2,941	2,887	.....	73
1917	15	100	3,386	3,331	.....	55
1920	20	100	5,532†	.....	.....	5,532
1923	25	100	8,791	5,249	\$3,542	.....
1924	25	100	11,151	9,665	1,486	.....
1925	10	100	7,161	7,013	.....	148
1926	10	100	8,092	7,978	.....	114
1928	16½	100	15,068	15,013	....	55
1929	20	100	21,177	21,145	....	32

\* 000 omitted.

† Stockholders waived right to purchase in 1920.

pects of a particular corporation, a marked general market slump always affects privileged subscriptions adversely. When a corporation wishes to ensure its receipt of cash at the time it is needed, the management has the subscription underwritten, even though it appears that the stockholders will gladly subscribe for all stock offered. The underwriting syndicate supplies insurance service only in such cases, since the corporation expects to sell its stock directly to its holders of outstanding stock. Bankers who are willing to undertake such underwriting risks should be in at least as good a position to forecast the security markets as is the management of the corporation wishing to issue the stock. Even bankers' opinions of the financial future are not infallible, and sizable losses are sometimes absorbed by the underwriting syndicate. However, the willingness or unwillingness of bankers to underwrite privileged subscriptions should give corporate managements some test of the probable success of their stock offering. Bankers' reactions might reflect not only the details of the plan proposed, but the timing of the offer of new stock.

Not all privileged subscriptions are underwritten. In some cases the corporation feels so sure that its new stock will be subscribed by its present stockholders that it does not care to pay the cost of underwriting it. This cost varies with the circumstances. Perhaps the most common charge in the nature of an insurance premium on all stock underwritten is 1 to 3 per cent. In addition, it is not uncommon to allow a discount of 2 per cent or more on the stock that the underwriters are required to take over. A great deal of stock offered in the form of privileged subscriptions cannot find responsible underwriters. If the stock already outstanding does not have a fairly broad market, bankers would hesitate to underwrite it. If they have anything to do with it, they would ordinarily prefer to buy it outright and undertake to make a market for it. The most highly speculative corporations would have difficulty in either selling their stock to bankers or in inducing them to underwrite it, even where the past record of earnings of the corporation is quite satisfactory.

This does not mean that underwriters never make mistakes in insuring the sale of privileged subscriptions. Even in the sale of bonds, there are opportunities for underwriting losses. One classic case that has been mentioned earlier in this chapter was the offer by the Bethlehem Steel Corp. of \$48,000,000 of convertible debentures in 1937. Because they were convertible, they were first offered to the stockholders. As noted already, only \$1,996,700 of these bonds were subscribed for by the stockholders. Fortunately for the corporation, the issue was underwritten. An adverse turn in the market occurred soon after the bonds were offered. With only about 4 per cent of the issue taken by the stockholders, the underwriters had to take over the remainder of the issue. It is understood that these bonds were first offered unsuccessfully by the underwriters at a price that represented a loss to them. As might be expected, it is difficult to find out just what does happen to such issues after they are taken over by the underwriters.

Another type of underwriting is that formerly undertaken by a company affiliated with the issuing company. For example, in 1931, the Electric Power and Light Corp. offered at \$15 per share its common stock to the outstanding holders at the ratio of  $1\frac{1}{2}$  new share for each share held. Electric Bond and Share Co. exercised its right to buy 567,845 shares and underwrote the remaining 872,500 shares at \$0.50 per share. As a result, Electric Bond and Share Co. became the owner of 57 per cent of all common stock outstanding. The use of the term "underwriting" hardly seems justified in such cases. The parent company simply takes over the unsubscribed shares of the subsidiary. With the passage of the Securities Act of 1933, this type of underwriting is looked upon with suspicion. At least the commission has insisted that all financial relationships between the issuing corporation and the security purchaser shall be disclosed so that the latter may better judge, for example, the fairness of the commissions paid.

## QUESTIONS AND SUGGESTIONS

1. What is the meaning of a privileged subscription? Under what circumstances is it used?
2. How much of the new stock can any stockholder purchase from the corporation?
3. What is a preemptive right? How does a stockholder acquire it? How may he lose it?
4. What is the legal justification for the use of preemptive rights?
5. In what kinds of situations does the preemptive right apply? Where does it not apply?
6. Why should stockholders be willing to waive preemptive rights?
7. How are convertible bonds related to preemptive rights? Does the same principle apply to refunding operations? Explain.
8. How are stock purchase warrants related to preemptive rights?
9. Do preemptive rights apply to the purchase of preferred stock? Explain.
10. In what sense may a privileged subscription become an obligation?
11. Upon what does the success of a privileged subscription depend?
12. What is a right? Differentiate between a New York right and a Philadelphia right. Which is more commonly used?
13. What determines the value of rights? May the market price on a particular day differ from the theoretical value? Explain.
14. Why may the announcement of a privileged subscription cause the price of the stock to advance?
15. What causes market prices of rights to fluctuate? If the stock is not listed, how will the price of the rights be determined?
16. Do corporate managements always know the best price to ask for the new stock? Why?
17. What dates are important in relation to rights?
18. How may a stockholder dispose of his rights to advantage?
19. How can a stockholder profit from a privileged subscription?
20. What happens to unsubscribed stock? Are all privileged subscriptions underwritten? Why?

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## SUBJECTS FOR INVESTIGATION

1. Find a privileged subscription, and state its provisions.
2. Within what range of prices did its rights fluctuate?
3. What proportion of the stock was subscribed for by those who held the rights?

## CHAPTER XXIII

### REGULATION OF SECURITY ISSUES

**Origin.**—It was not until recently that any serious attempt was made to regulate the issuance of securities by any type of governmental organization in this country. To be sure, laws that were intended to discourage fraudulent practices have been on our statute books for years. These were available to all who cared to appeal for their assistance. But the enactment of specific legislation aimed at fraudulent practices in the sale of securities appeared only a relatively short time ago. This is not surprising, in the light of our economic history. Until recent years, freedom of action rather than repression has been the chief characteristic of our legislation affecting business and economic affairs. Such laws as were passed in earlier years were intended to help rather than to hinder the plans of business leaders. We thought of our economy as one in which businessmen, rather than politicians, set the standards and made the decisions. Except for the mistakes and the excesses of those in control, this might still be the basis of our social and economic organization. But when enough people thought they saw in the actions of financial leaders the causes of their own misfortunes, it is not surprising that demands for corrective legislation became too insistent to ignore.

There are probably no reliable estimates of the losses suffered by those who purchased worthless securities. That the amounts are large is recognized by all students of the problem. One estimate covering the hectic decade of the 1920's, followed by the crash of 1929, places losses from worthless securities at \$25,000,000,000.<sup>1</sup> This may be a conservative estimate, since the decline of the computed value of stocks and bonds listed on the New York Stock Exchange from 1929 to 1933 amounted to more than three times this estimate.

**Blue-sky Legislation.**—It is not surprising either that our first efforts to control the sale of securities by legislative fiat should have occurred in an agricultural state, where financiers' voices were neither numerous nor loud. In order to rid the state of the pest of "high-pressure" salesmen of fraudulent securities, Kansas passed the first American blue-sky law in 1911. Being in the nature of revenge legislation, it is not surprising that this law placed upon a regulatory body duties which, if taken seriously, would have made the state of Kansas the investor of its citizens' money. In time, most of the

<sup>1</sup> *Senate Report 47*, 73d Congress, 1st Session, p. 20.



other states passed some form of blue-sky laws, few of which approached the original Kansas act in severity.

The theory behind such legislation is that, since the corporation is the creature of the state, the latter has a responsibility over the securities to be issued by the former. Two means are used to give voice to this responsibility: (1) the licensing of dealers and brokers, and (2) the licensing of specific security issues.

**Regulation of Dealers.**—Before a dealer or broker can obtain a license under blue-sky laws, he must demonstrate his solvency and financial responsibility. The act of registration enables the state to keep closer tab on security dealers and to apprehend those engaging in illegal practices. Various exemptions under the blue-sky laws need not concern us here.

**Regulation of Security Issues.**—Subject again to various exemptions, securities to be offered within the state having blue-sky laws must be licensed before they can be offered for sale. In general, the exemptions cover government securities; those regulated by other governmental bodies, such as public utility commissions and banking departments; and securities listed on specified exchanges. Tests employed by the various states, to determine whether or not to license securities, differ widely. In one, the character of the management of the enterprise is taken into account. In another, asset values are given particular attention. Earning power is stressed in still another. Apparently some blue-sky law administration has been based largely upon "hunch." Authority granted to blue-sky law administrators has not always been clearly defined. Forty-three states have regulatory laws that attempt to regulate the sale of securities by forbidding their sale until the state grants permission. Lack of uniformity in these laws and evasions through the device of interstate sales weaken their effectiveness. In some cases, strong-arm methods have supplemented specific legal authority. If a commissioner thinks, for any reason or for no reason, that the securities of a specific issue should not be offered to the people of his state, he may refuse them a license. The originator of the securities is more or less at the mercy of such a decision. Court action, if deemed expedient, may override the decision of the commissioner.

When securities are sold in violation of blue-sky laws, the sales are usually void, or voidable at the option of the purchaser. Fines and prison terms for violators of such laws are sometimes assessed as penalties for their violation.

**Administration of Blue-sky Laws.**—At the outset, difficulties of two sorts were encountered in the administration of blue-sky laws. Democracies are fairly prompt in sensing weaknesses that apparently merit legislative attention. But, upon passage of a law to overcome such weakness, we have a habit of sitting back with folded arms and congratulating ourselves upon our success in effecting the correction. Some years later, we may awake to a

realization that the law is not being observed because no one has assumed responsibility for its administration. This happened with some of our blue-sky laws. When administration was finally undertaken, it started with a vengeance and at times hampered even legitimate security sales with its red tape and numerous rules. A variety of practices among the different states also hampered legitimate operations of security salesmen. The organization of the National Association of Security Commissioners has helped to correct the latter by interchange of experiences and opinions.

**Antifraud Laws.**—A few states, without blue-sky commissions, have enacted antifraud laws as an aid to the apprehension and punishment of those who traffic in fraudulent securities. The theoretical difference between the two types of legislation is fundamental. Blue-sky laws are preventive in nature, while antifraud laws are punitive. In operation, the former may approach the latter whenever tentative approval is given an issue of securities, subject to subsequent withdrawal. In the few states that have antifraud laws, machinery for protection of investors is not set in motion until evidence is presented that fraud has been or is about to be committed involving the sale of securities. Willingness of victims to condone offenses and to accept compromises interferes with the effective operation of such laws.

Antifraud laws are favored by investment bankers in preference to blue-sky laws because, under the former, bankers are relieved from compliance with the preliminary requirements necessary to secure approval in advance of offerings of new security issues. In states where large amounts of securities originate, this may become quite burdensome. Delays made necessary through investigations by blue-sky commissions may prove costly on occasion.

**Ineffectiveness of State Laws.**—During the decade of the 1920's, when the greatest losses in history resulted from the issuance of worthless and even fraudulent securities, nearly every state in the Union had a blue-sky law of some kind on its books. The interstate nature of so many financial transactions, the easy means of evading the operation of state laws, and the indifference and unwillingness of security purchasers to use the means at hand for their protection conspired to make blue-sky laws ineffective in stopping the sources of worthless and fraudulent securities. Another weakness of state administration of blue-sky laws was the ever-changing nature of the commissions entrusted with the enforcement of such laws. Not enough administrators stayed on the job long enough to learn their powers and responsibilities. Even the laws themselves differed greatly in their provisions so that successful experience in one state was not an adequate guide to a new administrator in another. The approval of a uniform blue-sky law by both those who administered the various laws in force and

by the American Bar Association was not effective in securing the needed changes.

As a consequence, the experiences of the 1920's laid the foundation for the Federal laws that were passed in the early part of the 1930's. The state laws are still on the statute books. The Congress of the United States has attempted to make clear that it did not intend to have Federal laws supplant state laws on this subject. Instead it is clear that Congress meant to leave to the sole jurisdiction of the states such regulation of security issues as are wholly within the respective states. Nevertheless, it is evident that Congress came to the conclusion in the early 1930's that the proper regulation of security issues could not be left to the states, without the assistance of the Federal government.

**Suggestions for Federal Legislation.**—As early as the end of the last century, the United States Industrial Commission pointed to the need for more frequent and more accurate reports by managers and promoters of corporations. Every president of the United States for the next twenty years made recommendations to Congress for the Federal control of corporations engaged in interstate commerce. Congress took no action in response to these recommendations until the needs of the First World War resulted in the passage of a law to establish a Capital Issues Committee, whose function it was to direct the flow of capital into channels that would best serve the needs of the war. When this committee was discontinued at the close of the war, it took occasion to give Congress the benefit of its experiences by recommending that "federal supervision of security issues, here undertaken for the first time, should be continued by some public agency . . . in such form as to check the traffic in doubtful securities while imposing no undue restrictions upon the financing of legitimate industry."

This committee recognized that the tremendous number of people who had learned for the first time that property values are capable of being represented by a piece of paper, through their purchase of Liberty bonds, would add materially to the list of prospects for the sale of all kinds of stocks and bonds. Speaking of the broadened field of operations for the salesman of securities the committee added: "He now has the entire American public and the transaction becomes one of persuasion to trade—to trade a Government bond bearing a low rate of interest for stocks and bonds baited with high promise of high rate of return and prospect of sudden riches."<sup>1</sup>

During the period from the First World War to the year 1933, bills were introduced in Congress which sought to accomplish one or more of the following objectives: to require publicity of significant information concerning the actual or prospective results of issuing corporations; to prevent the sale of fraudulent securities through the use of the mails or interstate

<sup>1</sup> *House Document 1485, 65th Congress, 3d Session.*

commerce; and to provide Federal support for the enforcement of state blue-sky laws.<sup>1</sup> Even though some of these bills had the support of representatives of institutional investors and the Investment Bankers Association, the time was not yet ripe to enlist sufficient support to secure their passage.

**Background of Recent Federal Legislation.**—It is hardly conceivable that the Federal government could have passed the Securities Act during the decade of the 1920's. Then security prices were on the upturn. Millions of people thought they were making huge profits in the stock market. They were well satisfied with what they conceived to be the fruits of their own good judgment. So long as the rules of the financial game worked in their favor, they were not interested in any change in them. It is only when results fail to measure up to expectations that we are inclined to demand changes in such rules. In analyzing the conditions that resulted in the passage of the Securities Act of 1933, let us not overlook the cupidity of the millions of dabblers in the hectic stock market of the 1920's, whose knowledge of finance was not sufficient to enable them to discern just what was going on. Failing to understand the reasons for the sharp upswing of prices, it is not surprising that bewilderment resulted from the break in 1929.

One author, writing of the stock-market break of 1929 and its consequences, said: "There was a general feeling of bewilderment as to the exact nature of what had occurred, an instinctive feeling that there had been injustice, that fundamental structural defects in the economic mechanism had revealed themselves, and that something should be done about it."<sup>2</sup> Another statement appearing in a book that deals with the Securities Act accounts for its passage in the following language:

The Securities Act was launched by the Seventy-third Congress in an era in which disclosures in financial circles had shaken public confidence to its very foundations, and in which a considerable number of issuers were found to have grossly misinterpreted values and concealed essential facts—often in fraudulent or criminal transactions. It was actuated by the broad purpose of protecting investors and by a desire to restore public confidence to the investing public by a rigid surveillance both of instruments offered to them in new financing and of the methods by which existing securities were sold.<sup>3</sup>

Within the Congress, similar attitudes were commonly held as is evidenced from the following quotation from a Congressional report on the subject:

During the post-war decade some 50 billions of new securities were floated in the United States. Fully half, or 25 billions worth of securities floated during this period, have been proved to be worthless. These cold figures spell tragedy

<sup>1</sup>Cherrington, H. V., "The Investor and the Securities Act" (Washington, 1942), pp. 42ff.

<sup>2</sup>Shaffner, F. I., "The Problem of Investment" (New York, 1936), p. 345.

<sup>3</sup>Lasser, J. K., and J. A. Gerardi, "Federal Securities Act Procedure" (New York, 1934), p. 1.

in the lives of thousands of individuals who invested their life savings, accumulated after years of effort, in these worthless securities. The flotation of such a mass of essentially fraudulent securities was made possible because of the complete abandonment by many underwriters and dealers in securities of those standards of fair, honest, and prudent dealing that should be basic to the encouragement of investment in any enterprise. Alluring promises of easy wealth were freely made with little or no attempt to bring to the investors' attention those facts essential to estimating the worth of any security.<sup>1</sup>

Without passing upon the statistical accuracy of this quotation, it at least shows the temper of those in a position to "do something about it." The action took the form of the Securities Act of 1933. Like other New Deal legislation of the period, this act encountered little opposition. Its provisions struck a responsive chord among too many disappointed speculators to produce any organized opposition from those outside of Congress. The chief criticism came from those in government circles and out who thought the law as passed did not go far enough in its efforts to stop losses to purchasers of securities.

**Relation of Securities Act to British Companies Act.**—While the sponsors of the Securities Act were undoubtedly familiar with the British Companies Act and obtained inspiration from it, there are major differences between the two laws. The English act is an incorporation law that contains provisions for publicity concerning public offerings of securities; the American act assumes the continuance of a wide variety of incorporation practices among the various states and contents itself with an attempt to regulate the interstate sale of new securities. Because of this difference, the English law is primarily interested in the prospectus, while the American act is more interested in the registration statement upon which the prospectus is based. In England, promoters, directors, and every person who has authorized the issue of a prospectus are liable: in America, every person who signs a registration statement; every accountant, engineer, or appraiser who consents to the use of his name as a participant in the preparation of a registration statement; and every underwriter is liable. While both acts emphasize the disclosure of essential information about securities to be issued, the American law is more detailed on this point.<sup>2</sup>

**Aims of Securities Act.**—The aims of this act may be summarized as follows: (1) full disclosure of essential information about the new securities to be issued, (2) avoidance of any implication that certification by the government means guarantee of securities or recommendations for their purchase, and (3) accountability of sponsors of security issues for the repre-

<sup>1</sup> House of Representatives, *Report 85*, 73rd Congress, 1st Session, p. 2.

<sup>2</sup> Barnett, G. E., *The Securities Act of 1933 and the British Companies Act*, *Harvard Business Review*, October, 1934, pp. 1-18. See also G. O. May, *The Position of Accountants under the Securities Act*, *Journal of Accountancy*, January, 1934, pp. 9-23.

sentations made by them. In commenting upon the above aims in a release dated May 27, 1933, the Federal Trade Commission, under whose jurisdiction the administration of the Securities Act was first placed, said:

The public should thoroughly understand that the Commission is not authorized to pass in any sense upon the value or soundness of any security. Its sole function is to see that full and accurate information as to the security is made available to purchasers and the public, and that no fraud is practiced in connection with the sale of the security. Speculative securities may still be offered and the public is as free to buy them as ever.

This law has been called the Truth in Securities Act. It does not pretend to prevent the offer of speculative securities or even those of doubtful value. Its purpose is to permit intelligent appraisal of the securities offered. To accomplish this purpose, the act prohibits the use of interstate transportation or communication or of the mails in the offer of any security to which the act applies unless a registration statement has been filed in accepted form with the Securities and Exchange Commission and a prospectus in accepted form has been made available to the purchaser.

**Securities Covered.**—The law defines security to include

. . . any note, stock, treasury stock, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, pre-organization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, or in general, any interest or instrument commonly known as a security, or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of or warrant or right to subscribe to or purchase, any of the foregoing.

**Exempted Securities.**—Exemptions under this act include: (1) securities sold or publicly offered prior to the passage of the act; (2) government securities; (3) certain short-term commercial paper; (4) securities of non-profit corporations; (5) securities of savings-and-loan associations; (6) securities of interstate railroads under the jurisdiction of the I.C.C.; (7) securities issued by receivers and trustees in bankruptcy; (8) insurance and endowment policies and annuity contracts; (9) securities exchanged by the issuer exclusively with its own security holders, where no remuneration is paid in soliciting the exchange; (10) an issue sold wholly to residents of a single state or territory where the issuer does business wholly within that state; and (11) where the issue does not exceed \$300,000, if the commission finds that the public interest is protected without compliance with the act. In addition, certain transactions, essentially involving no public offering, are exempted.

The exempted securities may be classified into several groups: those which are already issued under the supervision of some other governmental

agency, such as the Interstate Commerce Commission, state agencies regulating savings and loan associations, etc.; government securities; evidences of indebtedness for the purpose of financing current operations and which represent transactions between the borrowing corporation and financial institutions like commercial banks which, presumably, are capable of obtaining the information needed to safeguard their own interests; small issues where there is little likelihood that the general investing public will be involved; and securities that are in every sense strictly intrastate in character.

Formerly only issues not exceeding \$100,000 were exempted from registration upon filing with the Securities and Exchange Commission a proper letter of notification. A recent regulation of the commission raises this limit to \$300,000 in any period of 12 months. Offerings may be made at the expiration of 5 days after such letter has been filed. During the 3 years ended June 30, 1945, the following amounts were exempted as small issues:

Fiscal year	Number of letters of notification	Aggregate offering price
1943	353	\$17,986,987
1944	427	21,933,944
1945	578	38,848,893

Securities that are exempted because they are strictly intrastate in character are negligible in amount, almost never equaling 1 per cent of publicly offered registered securities.

In addition, certain transactions in which securities are involved are exempted from the provisions of the act. Once the original issuance of the securities is approved, subsequent resales need not have the sanction of the Securities and Exchange Commission. These include not only ordinary brokerage transactions but direct resales by owners as well. The very important exemption of "private" initial sales has been discussed in another chapter.

**Amount of Exempted Securities.**—The amount of exempted securities has bulked large in the years since the Securities Act was passed. For the years from January, 1934, through June, 1939, the total issues offered for cash amounted to \$36,100,000,000. Of this amount \$9,600,000,000 was registered with the commission, while \$26,500,000,000 was not registered. The unregistered issues were distributed as follows: securities issued by the United States government and its instrumentalities, \$16 billion; by states and their subdivisions, \$6 billion; by contract or conversion carriers, \$1.6 billion; and \$1 billion by banks and nonprofit institutions.<sup>1</sup>

<sup>1</sup> T.N.E.C. *Hearings*, Part 24, U.S. Government Printing Office, 1940, p. 12690.

Admittedly the period covered is not a typical one. The amount of securities issued by instrumentalities of the United States government is unusually large for peacetime years. Also the amount of securities offered by business corporations was probably lower than normal during most of the period covered. The succeeding years—from 1940 forward during the war years—showed an even greater proportion of unregistered securities, due to the unprecedented issues of United States government bonds and again the absence of normal corporate financing, particularly for new business enterprises.

**Registration Statement.**—The registration statement, filed with the commission, is designed, according to the House Committee on Interstate and Foreign Commerce, which recommended the bill, “to reach items of distribution profits, watered values, and hidden interests that usually have not been revealed to the buyer despite their indispensable importance in appraising the soundness of a security.” The section of the law outlining the contents of the registration statement covers several printed pages. The information necessary to meet these requirements requires a fair-sized volume to record. In addition to prescribing the form of registration statement, the commission is empowered to require information that it deems appropriate or necessary even though it is not specified in the law.

Since the very basis of the Securities Act is the full disclosure of information that is intended to lead to intelligent judgment about the corporation, it is to be expected that the registration statement should be comprehensive in character. As already pointed out, in contrast to English experience, American emphasis is placed upon the registration statement. It is not surprising that objections should have been raised to some of the requirements of this statement. While the objections have usually been worded in terms of delay and cost, it is probable that promoters and financiers prefer not to furnish some of the information demanded. For example, they would probably prefer not to give detailed statements about the compensation received by high salaried executives, the commissions paid to underwriters and all other fees, a list of stockholders owning more than 10 per cent of the corporation’s stock of any class and “full particulars” about the interest of directors and executive officers, and a statement of the persons who are to be permitted to buy the securities offered at less than the market price. Until the passage of this act, information of this character was not supposed to be made public. It was considered to be the private affair of only those directly concerned.

Other information required by the registrations statement was less objectionable though still considered burdensome in some quarters. Among other items required were a recent balance sheet of the issuing corporation, supported by analyses of certain accounts such as reserves and surplus; profit and loss statements for recent years; the amount of stocks and bonds,



both before and after giving effect to the issues for which approval is requested, together with a detailed analysis of all stock and bond issues; and a statement of the disposition to be made of the funds that are to be raised by the sale of the securities under discussion. In addition, accompanying the registration statement, there must be filed a variety of documents, such as a copy of the corporation's certificate of incorporation, underwriting agreements, and contracts calling for bonuses.

**Approval of Statement.**—The purpose of submitting the registration statement to the Securities and Exchange Commission is to secure its approval, without which the sale of the securities would be unlawful. Approval may be given positively or by default of the commission. If it raises no objection within a period of 20 days after the statement is filed, the statement is considered to be automatically approved. Meantime, however, the commission is not limited to a simple approval or disapproval. It may call for additional information, withholding approval until the statement is properly amended. Even after the statement becomes effective, the commission is still permitted, within a limited time, to place a "stop order" against it. Such an order suspends its effectiveness until errors or omissions in the statement have been corrected. To obtain the desired information, the commission may instigate a complete investigation if it sees fit. In some cases the commission uses the more informal "deficiency" letter to secure corrections of inadequacies in registration statements. In fact this practice has become so common that it is considered an adequate substitute for the "stop order" in most cases.

Stop orders may be issued by the commission within the time limits established by the law, even after a part of the security issue has been disposed of. The progressive interpretation of this law by the Supreme Court of the United States seems to point to the power of the commission to pursue attempts to perpetrate fraud in the submission of registration statements. Even where the applicants have sought to withdraw their request for approval it now appears that, for the protection of the public interest, the commission may refuse to permit such withdrawal but may proceed to investigate all the facts of the case instead. At least court decisions have upheld the orders of the commission to deny requests for withdrawal after the registration statement became effective, even though no securities had yet been sold. In one case the Supreme Court upheld the request of the applicant for the withdrawal of its request for approval before the statement became effective.

In issuing a stop order the commission may, if it wishes, publicize its action and give the reasons therefor. Such publicity might do irreparable harm to the reputation of the applicant, if the reasons given by the commission should prove to be incorrect. On the other hand, if the published reasons are sound, the power to use such publicity might be a powerful

deterrent to discourage promoters and others from running the risk of having a stop order issued against them. Through such publicity, the commission will gradually build up a code of standard practices which should be a useful guide to those seeking future approvals for security issues.

**Prospectus.**—The registration statement gives the commission the information it needs to provide the basis of approval or disapproval of the offering of the securities for sale to the public. It would be a useful document for study by the prospective purchaser of the securities, provided that he were intelligent enough in financial matters to make use of it. Its bulk and the consequent cost of its reproduction for this purpose argue against its common use. However, the commission considers it a public document and makes it available for study at its offices or, by photostatic reproduction, elsewhere. Even this accommodation does not operate practically to give prospective purchasers access to the information they need. Nor is it always convenient for the prospective purchaser to study the copy of the registration statement that is kept at the office of those who undertake to sell the securities.

To provide the desired information in convenient form, the commission requires the preparation of a prospectus, whose form and content must be approved by it. This prospectus contains in abbreviated form the essential information presented in the registration statement. The commission is authorized not only to specify what the prospectus shall contain, but it may eliminate any statements that it does not consider necessary for the proper education of the prospective purchaser of the securities. Every person who is asked to buy the securities must be offered a copy of the prospectus. And every purchaser must be given a copy either at the time of the sale or previously. Since the prospectus is prepared as an aid to the sale of the securities, it is usually sent, in addition, to any one who asks for it.

Even in its condensed form, the prospectus is still too voluminous to be reproduced in all the advertising that the selling of the securities requires. Newspaper and radio advertising are used to call the security issue to the attention of those who might wish to receive copies of the prospectus. All advertising of this nature must be submitted, before its use, to the commission for approval. In this manner a serious attempt is made to do everything possible to make sure that the spirit of the law is enforced.

Realism compels the admission that, if the prospectus is too much abbreviated in form, it loses its capacity to give the intelligent security purchaser the information he needs to pass judgment on the offering. On the other hand, if it is too voluminous, it is not only expensive to print and distribute, but it tends to confuse even those few investors who have acquaintance with legal, accounting, and other technical presentations. In other words, the prospectus, in whatever form, carries no key to an understanding of its contents or to a proper use of the information contained

therein. Undoubtedly the investor who cannot or will not read and try to understand the information that is made available for his use will be inclined to assume that the commission has taken care of his interests in approving the issuance of the securities offered him. For such people, the nature of the prospectus is more or less a matter of indifference.

The 20-day waiting period, described earlier in this chapter, has been very unpopular with investment bankers because of their fear of unfavorable market changes. It prevents advance notice from dealers and others of the exact nature of their commitments. While the commission permits conversations and the distribution of descriptive literature in advance of the expiration of the 20-day waiting period, it frowns upon even gentlemen's agreements involving commitments of any kind. This preliminary literature has been dubbed a "red-herring prospectus" since it is supposed to attract followers. It would be difficult indeed to prevent it from developing at least tentative agreements to purchase blocks of the securities about to be offered. Because of this possibility, the commission has discouraged its use by requiring that all holders of "red-herring" prospectuses must be notified of any changes ordered by the commission. This requirement tends to nullify any gain that might otherwise accrue from the distribution of any prospectus before final approval by the commission.

**Costs.**—One of the criticisms leveled at the Securities Act of 1933, as amended in 1934, is the cost imposed upon the applicant for approval of the security sale. The registration fee charged by the commission is only nominal, amounting to only  $\frac{1}{100}$  of 1 per cent of the face value of the securities to be offered; but it constitutes only a small part of the total cost. The other costs include the payment of legal, accounting, and other fees for technical services. Where voluminous information is required, such costs may become quite large. Printing alone is no inconsiderable item when both the registration statement and its supporting documents and the prospectus are included. In spite of objections that have been raised to the costs incurred in specific cases, it does not appear that, in general, the costs are excessive considering the pioneering that always takes place in the administration of any new procedure. It is to be expected that, as procedures become standardized, some costs will be reduced somewhat.

**Penalties.**—Penalties for violation of the Securities Act are of two kinds—criminal and civil. The criminal section is simply stated. Any person who willfully violates any provision of the act or any rules and regulations formulated to make it effective is subject to a fine of not to exceed \$5,000, or imprisonment for not more than 5 years, or both. Civil liabilities are provided for the purpose of enabling injured persons to recover losses resulting from violations of this law. The sale of an unregistered security that should have been registered makes the seller liable to the purchaser. The purchaser may compel the seller to take back the security

and to refund the purchase price or, in case the purchaser no longer owns the security, he may recover damages.

Where the registration statement or the prospectus makes an untrue statement or omits to tell something that constitutes a "material fact required to be stated therein or necessary to make the statements therein not misleading," the seller of the security is liable to the purchaser. Again, the recovery is limited to the purchase price, or to damages, if the securities have been disposed of by the purchaser. For the limitations of time of bringing suit and other technical precautions that the plaintiff must observe in order to make sure of recovery, the reader is referred to a more technical summary of this law. It is significant to note that, like other civil actions, recovery is not automatic when a security purchaser suffers a loss due to the violation of a law by another person. (1) The loser must take the initiative in bringing a suit for recovery. (2) He must prove that the law under which the suit was brought has been violated. (3) He must try to collect under a judgment, if his suit is successful. Generally speaking, few suits are brought and even fewer judgments are obtained.

This does not mean that the penalty clauses of such laws are mere gestures. Their presence acts as a definite deterrent to wrongdoing. Those who might be willing to take a chance are given cause to pause and consider what the penalty might be if they are caught. Even where apathetic security purchasers take no action on their own account, it is generally possible for the commission to initiate proceedings against a violator of the law. This possibility frequently stays the hand of the law violator.

**Who Are Liable?**—In the effort to make this law effective in discouraging the flotation of worthless securities, Congress really combed the list of possible people who could be held liable for violating its provisions. The following persons are made liable for suits for recovery or for damages: every person who signs the registration statement; every director or partner of the issuing company and every one who, with his consent, is named as being or is about to be a director or a partner; every accountant, engineer, or appraiser who, with his consent, is named as having prepared or certified any part of the registration statement; and every underwriter of the security issue.

The underwriter particularly has received considerable attention from the commission. The Securities Act defines the functions of the underwriter and distinguishes between him and the dealer who secures only a sales commission. The commission makes inquiry to determine whether the underwriter is independent of the issuer or is controlled by the latter. In such case, the investor is entitled to know the facts. The fitness of the underwriter and the nature of commitments made to him are also investigated. Since the Securities Act places new responsibilities upon investment

bankers, the commission wishes to know if those chosen for a particular security issue can carry the load of their contract. Because of this added responsibility, it has become more common than formerly for all the members of the underwriting syndicate to become parties to the contract with the issuer of the securities. Formerly, one banker, known as the manager, made the contract with the issuing corporation and then made a separate contract with the syndicate members. The corporation was not formerly a party to this second contract.

In order to escape liability, any of the foregoing persons, other than the one responsible for issuing the registration statement, who cannot escape liability, must prove any of the following: (1) That he had resigned or taken steps to do so and had so notified the commission and the issuer and that he refused to accept responsibility for the registration statement; (2) that the part of the statement in question became effective without his knowledge and that he had so notified the commission upon discovering it; (3) that, after reasonable investigation, he had believed the commitments made in the statement to be true and that there was no failure to include all material facts. The "reasonable investigation" is that which a prudent man would be expected to use in the management of his own property.

**Administration.**—"No law is better than its administration" can well be applied to the Securities Act of 1933 and its subsequent amendments. As originally enacted, the administration of this law was entrusted to the Federal Trade Commission. With the passage of the Securities and Exchange Act of 1934, the administration of the Securities Act was transferred to the newly created Securities and Exchange Commission. The powers of the commission affecting security issues may be summarized as follows: to make rules and regulations governing the approval of security issues, including the form and content of registration statements and prospectuses; to interpret accounting, technical, and trade terms used in the act; to issue stop orders suspending the effectiveness of registration; and to secure from the courts injunctions restraining violations of the act and mandamus authority to compel compliance with its provisions.

For the most part, the commission has adhered to the standards established by the intent of the law. While the discussions and the debates that preceded the passage of the Securities Act emphasized worthless securities, the law itself attacks fraudulent acts and insists only upon full disclosure of facts with respect to other security issues. Where the investigations connected with the application for approval of the registration statement do not indicate fraud, the commission is given little discretion under the law to deny the application. Where there has been an evident intent on the part of the sponsors of a security issue to meet the requirements of the law without hesitation, the commission has not been inclined to interpose objections to the sale of the securities.

**Kinds of Fraud.**—Since fraudulent practices constitute the major target of the commission's activities, a brief review of the kinds of fraud practiced in the submission of registration statements is in order. In a few cases, the legal status of the applicant for the approval of the registration statement was misrepresented in a manner that might, for example, have placed partnership liability upon investors where no such liability was disclosed. The nature of the business and of the future plans of the applicant may not be clearly set forth in the registration statement. A favorite subject that is not clearly defined involves the relationship of the promoter to the enterprise, including the amount and kinds of compensation that he expects to receive. It is not always easy for those who draft registration statements to be truthful in describing the capacities and past experiences of those who expect to manage the corporation. Likewise, the relationships between the management and the suppliers of capital are exceedingly important to those who buy the corporation's securities. Yet they are not always defined in a manner that will give to outsiders a clear picture of the powers, duties, responsibilities, and sources of compensation of officers and directors. Even important contracts already arranged for which might influence the decision of a capitalist to buy or to refrain from buying securities are not always included. These may grant special advantages to officers or other favored parties at the expense of the people who put up the money.

With respect to the very important question of property valuations, it is recognized that the line between hope and realization cannot be drawn accurately in all cases. Only experience over a period of years will demonstrate true values. Even the commission admits that valuations are mere expressions of judgment that only experience can affirm or deny. Yet the commission has not been content to permit the substitution of pseudo-scientific formulas for better evidence of value. Nor has it been willing to admit the validity of valuation procedures where it was evident that someone was obtaining an undue advantage, as a consequence of high valuations unrelated to other disclosed facts of the case. The proposal to use the "doodle-bug" method of using a "mineral-indicator" contraption, consisting of a short cylinder and a leather thong, to determine not only the presence but also the quantity of the hidden ore has made the commission wary about truck gardeners who attempt to qualify as scientists.<sup>1</sup> The most difficult problem of the commission in dealing with the elusive subject of valuation is to attempt to discover the presence of fraudulent intent. This is not always easy.

**Other Effects.**—Outside the field of placing obstacles in the path of fraudulent promoters, it is difficult to appraise the gains, if any, made by the Securities Act and its administration to date. Legally, at least, it is still possible for promoters to make large profits from the sale of worthless

<sup>1</sup> Cherrington, *op. cit.*, p. 185.

securities. In doing so he cannot use the mails and the facilities of interstate commerce. Most of the other tricks of the trade are still available, in form at least, provided full disclosure is made of the plans in the registration statement. And if the prospective security purchasers do not study the prospectus and the registration statement, they will likely never know what favors to insiders they are parties to.

Actually, of course, the commission enjoys considerable power not specifically granted in the law. Some of it is only latent and is not likely to be called into use very frequently. For example, in a situation where the commission lacks information on which to deny an application for approval of a registration statement and at the same time is suspicious of the character of the securities to be offered, it can cause sufficient delays to suggest the withdrawal of the request. If the proposal is legitimate, repeated delays on the part of the commission could be overcome by an appeal to the courts. But if there is any question about the final judgment that might be rendered in the case, probably no attempt would be made to go over the head of the commission, in spite of the stalling tactics that it might see fit to employ.

Perhaps it is only the latent power of the commission that is the most effective protection to the investing public. The law never intended to prevent the promotion of speculative enterprises. Under the most honest and capable administration of the Securities Act, promotion of enterprises whose ultimate failure or success cannot be determined until they have been given a chance to operate for a few years at least is intended to continue. It is recognized that no amount of information that can be made available at the time of the presentation of the registration statement can prove the ultimate success or failure of an untried enterprise. And in like manner, the success of an expansion of existing corporations cannot be determined in advance of actual trial of the expanded program. But where actual fraud is present or intended, its detection should be much easier than prejudgment of the degree of success of an honest, even though mistaken, enterprise. The probability of detection of fraud will discourage the presentation of applications for the approval of the issuance of fraudulent securities. If the commission can prevent the presentation of applications for such issues, it will more than justify its existence. If it is not required to deny any such application because none is presented for approval, the major purpose of the Securities Act will have been well served.

On the other side of the ledger must be recorded some possibilities that are of quite a different character. A former chairman of the commission is responsible for the following statement: "The trend of decisional policy is not readily discoverable from the stop order opinions of the Commission. The nature of these reforms can only be found by an examination of the successive amendments made by issuers of securities prior to the effective

date—amendments in the hope that the corrected form of disclosure will avert the bringing of a proceeding.”<sup>1</sup> Without questioning either the integrity or the capacity of the author of this statement, one may question the consequences of star chamber proceedings conducted by a commission whose members are either incompetent or dishonest. Such possibilities at least lend emphasis to the statement that “no law is better than its administration.”

**Statistical Record.**<sup>2</sup>—During the first ten years of experience under the Securities Act, 5,420 registration statements were filed. Of these, 4,510, covering securities in excess of \$25 billion, became effective; of these, 173 were later withdrawn or became subject to stop orders. During the year ended June 30, 1945, 400 registration statements were filed. Of these, 345 with securities with a face value of \$3,224,000,000 became effective and 22 were withdrawn. At the end of the fiscal year, 81 applications for approval were pending and 182 were under stop orders.

Bonds and notes accounted for 63 per cent of all registered issues in 1945; preferred stock, 15 per cent; common stock, 12 per cent; and all others, including certificates of participation and face amount installment certificates, 10 per cent. During the same year, 98 per cent were offered by investment bankers, 81 per cent by purchase and resale, and 17 per cent on a “best-effort” basis. Only 2 per cent were offered by issuers directly to investors. Electric, gas, and water companies accounted for 47 per cent of the dollar volume of new issues; manufacturing, 29 per cent; finance and investment companies, 19 per cent; transportation and communication, 3 per cent; and all others, 2 per cent.

For the 10 years ended June 30, 1944, over \$22 billion of new corporate securities were offered for cash in the United States, of which two-thirds were registered and one-third were exempt from the provisions of the Securities Act. Slightly over one-half of the exempted securities were placed privately, and most of the remainder were issued with the approval of the Interstate Commerce Commission.

**Attitude of Investment Bankers.**—It might appear that the restriction placed by the Securities Act upon the sale of securities would cause resentment among those whose business involves the sale of new securities. For that reason it is of interest to read the testimony of a representative of the investment bankers. The president of the Investment Bankers Association of America, in discussing regulation of the security business said:

The fundamental doctrine of the Securities Act and the Securities Exchange Act, namely, full disclosure regarding new issues and continuing disclosure of the affairs of publicly owned companies—also the fixing of definite responsibilities for

<sup>1</sup> Landis, J. M., “The Administrative Process” (New Haven, 1938), p. 109.

<sup>2</sup> Compiled from Tenth Annual Report of the Securities and Exchange Commission, *House Document 158*, 79th Congress, 1st Session, *passim*.



care and honesty—these have the approval of the responsible elements in our business and in the entire community.

In discussing prospectuses, he said

. . . However burdensome is the preparation of the documents which must be filed under the provisions of the two Federal Acts, they do produce information for us to give the investor, which tells the complete story if he will but read it. . . . When the investment banker finishes the preparation of statements for filing with the Securities and Exchange Commission, he generally knows more about the company whose securities he is about to offer than he ever did before; and the same often may be said of some of the company's own officers and directors.<sup>1</sup>

**Limitations of Securities Act.**—While great expectations accompany the administration of the Securities Act, it must be pointed out that it cannot solve all the problems involved in the distribution of securities. The constitution limits its jurisdiction to interstate transactions—those in which transportation and communication and the use of the mails are involved. It cannot reach those corporations and securities which have only intrastate implications.

In the second place, as already stated, no law is any better than its administration. While great hopes are entertained about the effectiveness of this legislation, we have not yet had time to pass final judgment on its administration or to test the means that will be sought to evade it.

In the third place, the administrators of any law are limited in their effectiveness by the assistance given them by people who suffer from its breach. Unless investors report violations of this law and initiate proceedings to protect their interests, they cannot hope for relief. The law is not automatic in operation.

Finally, this law is not intended to provide a substitute for investor intelligence and discretion. Under the best of circumstances, it merely assists the purchaser of securities by giving him opportunity to exercise his intelligence and his discretion. If he does not or cannot do so, the law will be of little use to him except to limit somewhat the chances for him to make mistakes by discouraging the offerings of the wildest appeals for his capital expenditures. Undoubtedly the law will limit even if it does not eliminate the amount of wildcat offerings.

**Trust Indenture Act.**—Related to the Securities Act, yet separate from it, is the Trust Indenture Act of 1939. The Securities Exchange Act of 1934 places upon the Securities and Exchange Commission the responsibility for an "investigation of the work, activities, personnel and functions of protective and reorganization committees in connection with the reorganization, readjustment, rehabilitation, liquidation or consolidation of persons and

<sup>1</sup> Address before the Bond Club of New York, Apr. 21, 1937, pp. 3-4.

properties and to report the result of its studies and investigations and its recommendations to Congress." As a result of the investigation of the commission, Congress passed in 1939 the Trust Indentures Act with three major objectives in mind: (1) to make sure that bondholders are served by capable, competent, and disinterested trustees; (2) to keep bondholders informed about the financial status of the corporation whose bonds they hold; and (3) to provide a means by which bondholders may communicate with each other, should occasion arise which requires such contact.

The procedure of qualification of an indenture is similar to that for registration statements, with this difference: either the indenture meets the approval of the commission within 20 days or it is refused. If no action is taken by the commission within 20 days, it is estopped from subsequent intervention. Where no indenture is used, as much as \$250,000 of bonds may be sold without qualifying before the commission. Also where the amount issued does not exceed \$1,000,000 within a 3-year period, no qualification is needed, even though an indenture is used. In addition, bonds exchanged for outstanding securities without underwriting expenses and issues authorized by a court as a part of a reorganization program are exempt from this law.

The basic theory of this law differs from the Securities Act. The latter required disclosure only; the former sets up standards for bond-indenture contents. In addition, the commission is given authority to prescribe the information and documents that must be filed by the issuer "as necessary or appropriate in the public interest or for the protection of investors." Every issuer of bonds which uses a bond indenture must provide a corporate trustee with a capital and surplus of not less than \$150,000. The permissible relationships between the trustee and the issuing corporation are carefully defined in the law and in the regulations of the commission. In general, these are intended to make sure that the trustee is not serving the corporation to the possible disadvantage of the bondholders. At least semiannually, and oftener if necessary, the issuer of the bonds must provide the trustee with the names and addresses of all known holders of its bonds under the indenture. Any three bondholders who have held their bonds for 6 months have a right of access to this list for the purpose of communicating with other bondholders.

At least annually the trustee must report to the bondholders certain prescribed information concerning its relations with the debtor corporation. Special reports are required under specified circumstances. The duties of the trustee are defined in such manner as to eliminate immunity clauses in bond indentures and to substitute in their place the requirement that the trustee shall follow the "prudent-man" theory. The obligor under the indenture is also directed in the law concerning the reports that it must file and the obligations that it assumes. Penalties are similar to those provided under the Securities Act.

As existing bond issues are refunded and as new bonds are issued, a progressive increase in the amount of bonds protected by this law will result. The commission estimated that during the first four and one-half years of the operation of this law, one-sixth of the corporate long-term debt of country—exclusive of railroad bonds which are exempted—has become subject to the requirements of the Trust Indenture Act.

**Number of Indentures.**—The activities of the commission in administering the Trust Indenture Act during the fiscal year 1945 are shown by the following table:

	Number	Amount
Indentures pending as of June 30, 1944 . . . . .	6	\$ 163,500,000
Indentures filed during year . . . . .	117	2,207,284,320
Total . . . . .	123	\$2,370,784,320
Indentures qualified . . . . .	98	\$1,791,190,320
Principal amount reduced by amendment . . . . .	...	250,000
Indentures deleted by amendment or withdrawn . . . . .	3	107,295,000
Indentures pending June 30, 1945 . . . . .	22	472,049,000
Total . . . . .	123	\$2,370,784,320

### QUESTIONS AND SUGGESTIONS

1. Why was the regulation of security issues undertaken only recently?
2. How much did the purchasers of worthless securities lose in the decade of the 1920's?
3. What are blue-sky laws? How do they operate? How successful are they? Why?
4. How do antifraud laws differ from blue-sky laws?
5. What were the early suggestions for Federal legislation on this subject? Summarize the background of the Securities Act.
6. Compare the Securities Act with the British Companies Act. Account for any differences that you find.
7. What are the aims of the Securities Act?
8. What are exempted securities? Name several classes. What proportion of new securities are intrastate?
9. What is the registration statement? What does it cover? Why is this statement required?
10. What is a stop order, and how is it used? What is a deficiency letter?
11. What is the prospectus? Who is supposed to have access to it? Who determines its contents?
12. What has been the attitude of investment bankers toward the 20-day waiting period? Why?
13. What is a red-herring prospectus, and why is it so called?
14. What kinds of penalties are attached to violations of the Securities Act? Who are liable?

15. How is the Securities Act administered? What kinds of fraud does this law undertake to prevent?

16. If the Securities and Exchange Commission is suspicious of an application for approval but lacks proof of its suspicions, what can it do to prevent the sale of the securities?

17. What is the attitude of investment bankers toward the Securities Act?

18. What are the limitations of the Securities Act?

19. What is the Trust Indenture Act, and what are its objectives? How does it differ in principle from the Securities Act?

20. Does the Trust Indenture Act apply to bond issues outstanding at the time it became effective?

### SUPPLEMENTARY READINGS

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### SUBJECTS FOR INVESTIGATION

1. Summarize the contents of a prospectus approved by the Securities and Exchange Commission.

2. Obtain an order of the commission approving an issue of securities, and summarize the reasons for approval.

3. Obtain a copy of a stop order issued by the commission, and summarize the reasons for its issuance.

## CHAPTER XXIV

### SECURITY EXCHANGES

**Relation to Corporation Finance.**—To the casual reader, it might appear that there is only remote relationship between security exchanges and the financing of corporations. The financing of each corporation takes place first. After the corporation has enjoyed a sufficient period of successful operation to demonstrate its earning capacity and to permit its securities to become seasoned, it may succeed in getting them listed on some exchange. Until it reaches the degree of stability that this statement suggests, it would appear that the security exchange has little to offer to it. As a matter of fact, most corporations never succeed in getting their securities listed. Some stay out of the organized markets through choice and some through inability to qualify.

But this is not the whole story. While the influence of the stock exchanges upon the issuance of most securities is indirect, it is nevertheless important. For example, except for the wide publicity given to the changing prices of securities on the organized exchanges, it is very doubtful if millions of people would be actively interested in the purchase of stocks and bonds. Any device that results in facilitating the purchase and sale of securities or in broadcasting information about the trends in security prices increases interest in ownership of stocks and bonds. The publicity resulting from exchange transactions has an educational and advertising effect. People who might not become interested in the purchase of stocks and bonds learn something about them from daily stock quotations and from newspaper and radio publicity about market activity. Interest frequently develops into action merely through the contagious influence of watching prices go up. The purchase of particular stocks or bonds may not result from radio announcements or newspaper reading. But all the publicity surrounding organized stock exchanges widens the interest in the subject of stocks and bonds and helps to condition the prospective customer for a favorable response when he is approached by stock and bond salesmen.

Furthermore, the indiscriminating purchaser of securities does not draw sharp lines of distinction between listed and unlisted stocks and bonds. From conversations with friends and acquaintances, he knows that they are purchasers of securities. The fact that they may confine their purchases to those listed on organized exchanges may not be known to him or, if known, may have little meaning. He assumes that if he buys any stock or bond and

wishes to dispose of it the stock exchange will find a buyer for him. When he is induced to make a commitment to purchase any type of security, it may not even occur to him to inquire if it is listed. If he should inquire, he may be told—in all sincerity—that the issuing corporation plans to secure its listing at an early date.

Finally, the transition from the purchase of securities through a stock exchange to the purchase through any other channel is not difficult. If a security buyer has been successful in his purchase of listed securities, he may feel that he has acquired an experience that he can capitalize in the purchase of an original issue of stocks or bonds. One of the selling points sometimes used in the sale of original issues is that they yield a higher return because they do not have the disadvantages of listed securities. While marketability is a desirable quality for those who expect to dispose of their securities quickly, it costs something and may not provide an offset to those who plan to hold their securities indefinitely. Even those who have been unsuccessful in speculating in listed issues may decide that their luck will change for the better if they switch to the purchase of new and unseasoned issues.

**Marketability.**—The direct advantages of security exchanges center about the question of marketability. Many security holders prefer to have at least a part of their funds invested where they can be converted into cash at a moment's notice. The reasons for this preference may be different in the case of some investors than with others. One reason may be more important than another if the circumstances favor the former. Marketability is that quality of a security which enables its owner to dispose of it to the best advantage in the shortest time. A security exchange provides a meeting place of buyers and sellers, or their representatives. It also provides a representative group of potential buyers and sellers which is necessary to prevent wide fluctuations in price changes. If the exchange were merely a meeting place of buyers and sellers, it is conceivable that an unbalanced division between two groups might easily result in rapid changes between buyers' and sellers' markets for individual securities. But when one thinks of the New York Stock Exchange, for example, he includes with that historic market place on Broad Street in New York City its hundreds of members, their thousands of correspondent dealers, and the millions of potential buyers and sellers of securities throughout the country. It is this broad basis of potential demand for and supply of listed securities that gives those which are listed on the "big board" the high degree of marketability which they enjoy.

To be sure, marketability is a relative term. Even among listed stocks, some transactions appear on the stock ticker every few minutes, with small fractions of a point between successive sales; others are bought and sold less frequently, but still the spread between successive sales is not normally very great; and still others have such a relatively small demand that sales occur

quite infrequently and then perhaps with wide spreads in price between successive sales. It must be recognized that the listing of a security on a stock exchange does not create a demand for it. It merely provides an opportunity for potential buyers and sellers to be represented at a designated time and place where a sale may take place. Since many security owners have a decided preference for the quality of marketability, they are willing to pay a somewhat higher price for listed than for unlisted securities.

**Collateral Value.**—Both individuals and business institutions find it easy to use securities for collateral in borrowing money. In the original purchase of securities, it is common for the purchaser to pay down a part of the purchase price and to use the security purchased as collateral for the purpose of borrowing the amount needed to complete payment for the purchase. In some cases, subsequent installment payments absorb the amounts borrowed. Or, if securities are already owned, they may be used as collateral in obtaining loans for any purpose. Banks and others that make loans on collateral security have a decided preference for listed securities. They can know currently what margin of protection they have on their loans. The percentage that can be borrowed on any specific security depends upon the lender's attitude toward it, which in turn is determined by a number of factors like the activity of its market, the extent of its distribution, and the usual spread between successive sales.

**Barometer.**—The owner of an unlisted security never knows what he may get for it until he offers it for sale. If he owns securities that are dealt in on any of the organized exchanges, on the other hand, he can tell day by day, or hour by hour if he is near a stock ticker, what valuations others place upon his stock or bond. A study of the quotations listed in many newspapers will not only give the prices of specific securities but will afford an index of price changes over any period of time. None would question that changes in security prices show what is happening to specific stocks and bonds. There may be some question as to why it is happening. And there is always opportunity to debate what market trends forecast. Some contend that the provision of an open market for security transactions is a cause of price fluctuations, *i.e.*, that listed stocks go higher in bull markets and lower in bear markets because it is so easy to accomplish their purchase and sale. The question of the forecasting ability of price changes has never been settled. Some think that security markets forecast by some months the future state of business. Opposed to this view is the fact that the correlation between prices of securities and indices of business conditions has not been close enough to prove anything in particular. Also it must be remembered that the stock market is made up of tens of thousands of buyers and sellers whose information and whose logic are less powerful in determining their conclusions to buy or sell securities than their hunches and their emotions

which feed upon tips and rumors. Many of them are inclined to buy when prices are high and to sell when they are low.

**Other Advantages.**—Among the other advantages of stock exchanges to security purchasers are a group of conditioning factors that together tend to give the prospective purchaser a greater feeling of protection when he buys listed securities than when he buys others. There is a general feeling that the standards of fair dealing with the public are higher for those corporations which list their securities on some exchange. Even before the legislation was passed to provide for the regulation of the exchanges, the public felt that the exchanges themselves did considerable to make sure that the rules of the game were fairly drawn up and that they were pretty well adhered to. Brokers who deal in listed securities are thought to be more honest and more dependable than the general run of security salesmen. Again the rules of the exchange help to maintain higher standards of customer relationships. Every person who has an account with a broker takes some risk in turning over cash or its equivalent for a period of time. Exchange rules aid materially in protecting the balances of those who deal with exchange brokers. Buyers of securities that are listed on some exchange know that the commissions paid are determined by the exchange on the basis of general principles rather than by what the seller can get in a particular situation.

In general, it may be said that security exchanges acquire a reputation that is worth considerable to their members and their correspondent dealers. Because this reputation is a source of profit to them, they are inclined to guard it jealously by their own conduct and by their insistence that other members deal fairly with their customers. Anything that hurts the reputation of a stock exchange is reflected in the decreased profits of those who depend upon it for a living. Its members dare not adopt the fly-by-night methods that have been instrumental in lining the pockets of unscrupulous salesmen of worthless stock in the past. This does not deny the need for regulation, as subsequent discussion will show.

**Listing of Securities.**—Since the securities exchange is a place that is supposed to be an open market for the stocks and bonds offered there, some means must be found to determine just what particular securities should be admitted to trading. This method is known as "listing." The securities are listed by the exchange authorities, upon application by the issuing corporation. No application will be considered except from a going concern that possesses either substantial assets or has a record of demonstrated earning power. Assets are normally expected to be at least \$5,000,000 and annual earnings at least \$500,000. The listing committee is not bound by these amounts in cases where its members consider assets and earnings adequate to attract public interest. Even when both of these requirements are met, however, the exchange may reject the application for listing. In



addition, the Committee on Stock Listing of the New York Stock Exchange gives attention to such subjects as the standing of the applicant in its industry, the character of the market for its products, its future prospects for expansion and for maintaining its current standing, and evidence of the interest of the security buying public in its securities.

To obtain this information, the committee requires the applicant to file a report which, among other information, contains a description of the business, property, products, earnings, and prices of the securities of the applicant; a financial report for the preceding five years; a statement showing the present distribution of its securities; a description of the applicant's relationship with subsidiary corporations, including a description of the capitalization of the latter and the part thereof which is owned by the applicant; information concerning present managers, including their other business affiliations; the number of employees and the labor policies of the applicant; the dividend record, with stock dividends shown separately, for the preceding five years; an analysis of the capitalization and the changes therein during the past five years; the terms and conditions of any outstanding stock purchase warrants or options, conversion rights or other commitments that call for the issuance of any classes of securities; the rights, preferences, priorities, and privileges of securities for which listing is requested; the applicant's accounting policies on such questions as depreciation, sources of circulating capital, pricing of inventories, etc.; and miscellaneous general information.

**Future Information.**—In general, it may be said that the purpose of requiring the information upon which a decision concerning an application for listing can be based is to supply the exchange with information that will support the claim that there is a probability that there will be an open market for the security, if it is admitted to trading. In addition to the information submitted in support of the listing application, every approved corporation must sign a formal agreement which provides that any important changes in the corporation's policies will be reported promptly to the exchange. These include changes in the certificate of incorporation or the by-laws; changes in the nature of the business, including the sale of a substantial part of the capital assets; issuance of stock purchase warrants or options; changes in the amount of treasury stock; changes in accounting policies; and such other information as the exchange may reasonably require.

Each corporation whose stock is listed on the New York Stock Exchange agrees to publish and distribute to its stockholders an annual statement, containing information in approximately the same form as the income statement and balance sheet submitted with the application for listing. These statements must be audited by an independent auditor, and his certificate must be attached. The stockholders must be given prompt notice of any action of the corporation involving the declaration of dividends or the issu-

ance of rights to subscribe to additional stock. The agreement covers also certain other relationships between the corporation and the stockholder, such as the requirement of at least 10 days' notice of the closing of transfer books.

The agreement gives the exchange the right to prescribe the form and content of the certificates of the securities to be listed. Stock certificates must recite the name of the owner, whether the stock is par or no-par, whether the shares are fully paid and nonassessable, and the rights and preferences granted to the holders of the stock in question. Bond certificates must include the terms of payment, the conditions under which they are issued, whether or not the corporation pays any taxes for the bondholder, sinking-fund provisions, conversion rights, the terms of redemption, and certain formal requirements. No changes in the form of any listed securities can be made without the approval of the exchange.

**Advantages of Listing.**—It should be noted that the exchange has no machinery for auditing or otherwise checking on any statements submitted by any corporation. It relies upon the honesty of the reporter. Hence it cannot guarantee the accuracy of the information submitted to it. Neither does the exchange undertake to sponsor any security that it admits to listing. Acceptance for listing must not be interpreted to mean a recommendation for the purchase of the listed security. Rather the exchange hopes that the securities offered are issued legally and without fraudulent intent. Beyond this, it merely provides a meeting place for buyers and sellers and puts all of them on notice that they must take responsibility for their decisions to buy or to sell particular securities.

In spite of what is said above, the buyer of a security relies upon the listing of a security to protect him against the purchase of illegally issued securities or those that may be counterfeited. This reliance is in the form of his own peace of mind rather than as a cause of legal action against the exchange. Assuming that such reliance is justifiable, the listing of securities affords certain definite advantages to the security purchaser. He can get certain information about the corporation if he asks for it.

To the issuing corporation, the listing of securities offers certain advantages. To the extent that security purchasers have a preference for listed stocks and bonds, the corporation gains a wider market and probably a higher price for its securities. This wider market will help to advertise the corporation and its products. If the holders of outstanding securities are satisfied with their commitments, they provide a market for whatever new financing the corporation may need. Listed securities offer an appeal also to those who are not already owners of the corporation's stocks and bonds.

**Disadvantages of Listing.**—The advantages of listing of securities are directly related to the added marketability that transactions on an organized exchange provide. Likewise, the disadvantages of listing center around the

same quality of marketability. Easy purchase and sale of securities tend to make speculators of many who would otherwise be content to invest their money and depend upon an income return. The promise of larger and quicker profits through speculation invites the use of security exchanges to buy and sell stocks in the hope of guessing right on market changes. Even those who persist in the investor point of view for a time are frequently led to sell out their holdings when prices drop even though dividends are still maintained. Stocks that have paid the same dividend for years, during prosperity and depression, would cause less concern to their owners if their price fluctuations were unknown.

Marketability also becomes a disadvantage from the standpoint of the corporation under the following sets of circumstances. Managers tend to become speculators, even to the neglect of their duties as operators and their responsibilities to protect the interests of those whom they serve. In pursuing speculative activities, managements may use their inside information to make profits in the purchase and sale of their corporations' securities. If they are so inclined, they may even make their decisions affecting the policies of the corporation in terms of their effect upon the prices of its securities. To discourage short-term speculation by corporate managers, the Securities and Exchange Act provides that any profit made by an officer or director, through the purchase and sale of the stock of the corporation with which he is associated, is recoverable by the corporation if the period between the purchase and the sale does not exceed 6 months. Short sales of stock by officers and directors are forbidden by this law.

Even where corporate managements are not actively engaged in buying and selling securities on their own account, their interest in market quotations may affect their judgment in determining corporate policies. If some policy would result in a long-run benefit to the corporation but might have an immediate adverse effect upon the price of its securities, the directors and officers will pay attention to this fact. If they do so to protect those whom they represent, a postponement of the desired policy might be desirable. But if their decision is based upon a fear that their own holdings might be adversely affected temporarily, the action taken must be considered differently. Marketability might even result in the development of opposition to the present management, if it puts into effect a policy that might depress the price of the corporation's stock, even though otherwise the adoption of the policy might be plainly indicated. This suggests that market reactions to corporation policies are not always logical or well advised. The market is most likely to give primary attention to short-term consequences, in spite of its so-called forecasting ability.

**Manipulation.**—Even though managements may be entirely free from speculative tendencies, listing of securities may invite their manipulation by other speculators. A speculator is a buyer or a seller who hopes to make

a profit from changing prices of securities. He is concerned only incidentally with the welfare or the success of the corporation as a producer or a distributor of economic goods and services. Indeed both success and failure are grist for his mill. If the corporation is doing well, he can try to profit by the increase in the prices of its securities. If it is faring badly, he can try to make a profit while the security prices are falling. The so-called "professional" speculator may even go so far as to try to manipulate the prices of a corporation's securities in such manner that the impression that buyers and sellers receive may be just the opposite from actual results of operation. In this operation, the professional speculator is aided by the unintentional assistance rendered him by the kind of uninformed speculator who buys and sells when he is influenced by tips and rumors.

If the pool that is manipulating the stock is successful in convincing the other type of speculator that the rumors of a melon cutting, a merger, or whatnot is about to take place, its members can sell out at higher prices the stock that they have bought at lower prices. If, on the other hand, professional speculators are short of a stock and they can induce others to act on their tips to the effect that dire things are about to happen to the corporation, they can drive down the price of the stock and cover their short sales at a profit. Manipulation of this character is possible only with listed stocks and under conditions where those whose uninformed decisions are needed to make the plan succeed can see that what has been predicted is actually happening. When they see the stock go up, thereby justifying in their minds the rumors they have heard, they help it to go up further by their purchases. When they watch the market to see if unfavorable tips seem to be justified, they assist the decline in prices by hasty selling.

**Other Disadvantages.**—Among other possible disadvantages of listing may be classed the loss of control and the adverse effects upon the credit standing of the corporation. While not to be taken too seriously, easy marketability of stock may result in its purchase by those who are antagonistic to the existing management. Such a shift of control is almost always possible where there is an open market for the stock. While it is seldom brought about, corporate history records various spectacular successful fights for changes in management by taking advantage of the privilege of buying a controlling interest in the stock in the open market. Had the stock not been listed, it would still have been possible, though certainly not so easy, for a group of outsiders to buy up a controlling interest.

In considering an application for a loan from a corporation, a bank or other financial institution always considers, among other factors, the prices of its securities. If its prices are low, due to no fault of its own but because the prices of all listed securities are depressed, its credit standing may be adversely affected. Bankers and other lenders of money are not free from depression-mindedness. And whether the depressed condition of security

prices is temporary or permanent, the effects are the same. A decline in credit standing, due to low security prices, will also have an adverse effect upon any other plan for raising new capital. Again, however, this effect of marketability should not be taken too seriously. It is likely that the credit standing of all corporations suffers more or less in periods of depression when all security prices are low, whether their stocks are listed or not.

**Margin Trading.**—Margin trading depends for its justification upon its similarity to the universal use of credit transactions throughout our economic system. In form at least, a purchase of stock on margin is simply a purchase on installments. If A decides to buy 100 shares of United States Steel Corp. stock at \$50 per share but has only \$2,000 in cash, he asks his broker to arrange to finance the remainder of the purchase price of the stock. This is a margin purchase. In carrying out the parallel with the purchase of a home through the use of a mortgage, presumably the purchaser of the stock would eventually repay the \$3,000 which the broker has borrowed for him and would own the stock outright. It is interesting to note in this connection that when we talk about the installment purchase of a house or an automobile we speak of buying on installments. The implication is that the purchaser will eventually own the thing purchased. In talking about stock margins, on the other hand, we speak about margin "trading," suggesting continued buying and selling rather than eventual ownership.

Actually the margin trader seldom expects ever to own the stock. He puts up as little margin as he must, hoping for a rise in the price of the stock so that he can make a higher percentage of profit than if he owned the stock outright. For example, had he used his \$2,000 to buy stock for cash, he could have purchased 40 shares. If the stock goes up 5 points he would have a paper profit of \$200; whereas if he purchased 100 shares on margin, he would have a paper profit of \$500, disregarding in each case commissions and carrying charges. By the same token, a drop of 5 points would produce a paper loss of \$500 on margin trading, in the illustration used, as against only \$200 if the stock was purchased for cash.

The tragedy of margin trading is that so many people who engage in it know so little about it. More often than not, their greed is the cause of their downfall. Not content with a reasonable chance at a profit, they try to spread their margin as thinly as possible. By this means, they overtrade and are vulnerable to any adverse influence upon stock prices. They are prone to miss their chances for a reasonable profit, even when it is presented. They reach for the ultimate increase in the stock price and overstay their market. If the market goes against them, they hesitate to limit their losses by a sale below the price at which they purchased the stock, always hoping for a price recovery that will absorb their loss. For years, the governors of the New York Stock Exchange have recognized the

evils of overtrading induced by thin margins. They have urged brokers to insist upon "proper and adequate" margins—and then have permitted each broker to determine what is proper and adequate. It was not until the passage of the Securities Exchange Act of 1934 that any attempt has been made to set up standards for margin requirements. Even present regulations are not intended to eliminate margin trading. And of course there is no means by which the margin trader can be prevented from losing money in stock-market speculation.

However, there are occasions when governmental authorities undertake to discourage certain types of speculation by requiring larger margins for stock purchases. These margins may even be raised to 100 per cent, resulting in cash purchases only. It is not at all certain that high margins may not result in thin markets for stock and thereby produce wider fluctuations of prices than otherwise.

**Selling Short.**—One feature of security trading that has been the subject of a great deal of controversy for many years is the short sale of stock. Essentially a short sale is a sale of something that the seller does not yet own. If *A* thinks \$90 per share is too high a price for the common stock of the U. S. Steel Corp. and that this price will soon be lower, he may wish to make a profit from his deductions. He goes to a broker and deposits the required margin of, say, \$3,000, directing the broker to sell 100 shares at \$90 per share. The broker borrows 100 shares of stock and sells them through the exchange, making delivery with the borrowed stock. Assume that the price drops to \$75 per share and that the seller decides to take his profit. He now directs the broker to buy 100 shares at \$75. This stock is then delivered to the party from whom the original stock was borrowed. The short seller has now "covered" his short sale and has made a profit of \$1,500, minus his commissions and other buying and selling costs. In case the stock went up to \$100 per share instead of down to \$75 and the seller decides to "cover," he suffers a loss of \$1,000.

It is not within our province to discuss in detail either the mechanics or the economics of the short sale. Standard texts on the stock market will give the details of the former and the pros and cons of the latter. As in the case of margin trading, short selling invites the participation of the speculative neophytes, whose knowledge of the causes of fluctuations in security prices is not very profound. Admission that short selling has legitimate uses does not carry with it an approval of its use by all who try to make a profit from it. Like margin trading, short selling has been subject to recent regulation by the Federal government.

**Organization of Exchange.**—Although there are numerous organized exchanges throughout the United States, the New York Stock Exchange occupies the dominant position in the listed-securities market. For that reason, the interest of most people centers in its operation. The discussion

that follows deals with this one exchange. It originated in an informal meeting of traders in the evidences of the national debt as early as 1792. For a quarter of a century, this exchange had no formal organization and no home. It was not until 1817 that it adopted a constitution and moved indoors. Since its organization, it has played an important part in the financing of American corporations and in the development of American industries. According to the latest information available, it has listed 1,269 stock issues, involving 1,592,111,825 shares of stock, having a market value as of Dec. 31, 1945, of \$73,765,250,751.<sup>1</sup>

Each member has a "seat" on the Exchange which is his personal property and which gives him the right to the use of its facilities. While we speak of the open market for securities, only members are permitted to buy and sell securities directly through the Exchange. All others must use these members as their agents. The bull market of the late 1920's witnessed the latest increase of membership—to 1,375. The all-time high for the price of a seat was experienced in 1929 when it reached \$625,000. Later interest in stock speculation dropped to such low levels that subsequent sales for as little as \$20,000 have been consummated. As a matter of fact, there has been talk of reducing the number of seats to make those remaining more valuable. It should be added that ownership of a seat is only one of the qualifications for membership on the Exchange. In addition, the applicant must prove, to the satisfaction of the Committee on Admissions, that he possesses the requisite character and fitness for admission to membership. Until the passage of the Securities Exchange Act of 1934, the Exchange was governed solely by a committee. Since 1938, it has had a full-time salaried president. Commission schedules for the charges set by all members are fixed by the Exchange. Advertising material is supervised by it. Examiners audit the books of the members to see that customers' interests are being protected.

**Types of Brokers.**—The kind of broker with which the public is most familiar is the commission broker. With offices in the financial district of New York and with branch offices scattered throughout the country in office buildings, in hotels, and in other places convenient to the buying public, commission brokers execute buying and selling orders for their customers. The commissions charged are fixed by the Exchange. Usually a "board" is installed in each branch office where the "sitting" customers may watch the progress of price changes of their favorite securities. In active markets, the commission broker is assisted by the "two-dollar" broker who executes buying and selling orders for the former, receiving for his services \$2 per hundred shares. Since he has none of the trouble and worry of maintaining customer relationships, he can afford to accept a fraction of the total compensation to help the commission broker to execute his orders promptly.

<sup>1</sup> *Commercial and Financial Chronicle*, February 4, 1946, p. 702.

The odd-lot broker deals in less than 100-share orders and executes buying and selling orders for small investors and speculators. The odd-lot broker runs some capital risk in the filling of his orders. Suppose, for example, that he has three orders to buy, respectively, 15, 25, and 40 shares of United States Steel common at the market. In order to execute these he must buy 100 shares, let us say. This leaves him with 20 shares on hand which may go down in price before he can dispose of them. This element of risk accounts for the fact that only houses which can attract a large volume of odd-lot business can afford to take the chance of loss. The number of odd-lot brokers is very small. Others do not find this a profitable kind of business. This attitude may change, as is indicated later in this discussion.

**Floor Traders.**—Some Exchange members have no offices for the accommodation of customers and little or no staff of employees. They are not interested in earning commissions on purchases by and sales to investors and speculators. They are known as "floor traders." Instead of acting as agents for others, they serve in the capacity of principals. In making purchases and sales on their own account, they have a slight advantage over others interested in security transactions. As members of the Exchange, they pay no commissions. They are distinctly traders in securities, ready to buy or sell upon the emergence of what appears to be a profitable opportunity. A stock whose price seldom fluctuates has no interest for the floor trader. He thrives on price changes. He is never interested in the long-run possibilities of a stock. It is the fluctuations from hour to hour or within even shorter periods of time that give him his opportunity for quick profit. If he makes a mistake in his conclusions, he suffers a quick loss instead. He is either a "bear," hoping for a decline in the price of a stock that he has sold short, or a "bull," hoping for an increase in the price of his purchases, as the occasion requires.

**The Specialist.**—The specialist is a member of the Exchange who combines the functions of the commission broker and the floor trader in relation to a special list of securities. In the trading on the Exchange, securities are concentrated, by classes, in various parts of the room. A specialist remains at the "post" where the security or securities in which he specializes is located. In a fast-moving market, it is important that the agent for the buyer or the seller be present when a stock price reaches his "limit." Suppose, for instance, that a specialist has on his pad an order to buy 100 shares of U.S. Steel common at 90½. Suppose that the market opens at 91¼. Unless he is at the proper "post," should the price drop to 90½, it may recover and not sell again that low. He will have failed to execute the order. Commission brokers frequently leave "limit" orders to buy stocks and "stop-loss" orders to sell with specialists. The "stop order" is a device for protecting the purchaser of stock against too drastic a decline in price. Suppose, for example, that a stock is selling at 63¾. The owner



20 per cent of the total sales on the New York Stock Exchange. The average number of shares per transaction is around 25. Because of the relative importance of this kind of business, the Exchange changed its rules in the summer of 1942 to reduce the unit of trading for a selected list of fairly inactive stocks to 10 shares. It was understood that the stocks selected were expected to serve as a "trial balloon" to determine the desirability of this kind of trading on the exchange. It was hoped by this means to stimulate business for a slow market.

According to the report of the Securities and Exchange Commission for the year ended June 30, 1945, the weekly purchases by customers from odd-lot dealers during the year varied from 13,904 orders involving 387,200 shares, with a market value of \$16,526,051, to 34,380 orders, involving 1,071,464 shares, with a market value of \$40,471,337. During the same year, odd-lot sales by customers to dealers and specialists varied from 13,870 orders, involving 354,203 shares, having a market value of \$12,838,085 to 35,992 orders, involving 1,033,381 shares, having a market value of \$37,826,299. From the information supplied by the commission, odd-lot purchasers are traders rather than long-term investors.

**Block Sales or Special Offerings.**—At the other end of the line there has developed a great deal of business in stock transactions which by-pass the organized exchanges. This applies particularly to purchases and sales that involve unusually large numbers of shares. During and immediately after the stock-market break of 1929, frequent sales of large blocks of stock were arranged "off the floor."<sup>1</sup> During the Second World War foreign governments disposed of large blocks of stock, sometimes amounting to tens of thousands of shares each, in this manner. Estates frequently dispose of their stock in large blocks. Investment trusts are frequent buyers of unusually large amounts of stock. In fixing the prices of such sales, the going prices on the New York Stock Exchange are used as the base. In this manner the Exchange renders a service, but its members are not compensated for it.

Such block sales are known as secondary distributions or "dusk-to-dawn" sales. While the public offering price is usually the closing price on the exchange, the seller receives an amount that grants the "dealer" a concession sufficient in size to induce him to try to create a demand for the stock. This is accomplished by telephonic and telegraphic communication with prospective buyers and by the contacts made by the dealer's salesmen. The dealer buys the entire block of stock from the estate or other former owner and distributes it to the customers he has been able to interest in it. In offering it to them he is able to quote firm prices for it. The *Wall Street Journal*<sup>2</sup> records such a sale of 28,700 shares of General Electric Co. stock

<sup>1</sup> Schultz, B. E., "The Securities Market" (New York, 1942), p. 393.

<sup>2</sup> For Aug. 19, 1942.

to 58 purchasers, whose purchases ranged from 10 to 10,125 shares each. The demand was so great that the shares were allotted on the basis of 38 per cent of the amounts ordered. As indicated, these secondary distributions are consummated outside the exchange and after exchange hours.

Other block distributions, known as "special" sales, take place through the usual exchange channels. Here the offering may continue over an indefinite period of time, as fast as the market will absorb the stock without unduly depressing prices. The broker who handles the offering buys the stock either for himself or for his customers. He may receive a special commission to accomplish the sale. Again the telephone and telegraph may be used to find buyers. The commission reports for the year ended June 30, 1945, 82 special offerings completed through security exchanges. These involved 984,346 shares of stock valued at \$30,504,000. Of the 82 issues sold, 46 offerings terminated within 15 minutes, 32 the day offered, and 4 at a subsequent time. During the same year 11 issues of 164,075 shares were offered, but only 130,855 were sold. One offering was terminated on the day offered and 10 at a subsequent time. Since there is a conflict between "specials" and "secondary" distributions, because one uses the facilities of the exchange and the other does not, secondary distributions are usually handled only by dealers who are not members of the exchange on which the stock to be sold is listed.

Among the blocks of stock disposed of through special sales and secondary distributions during 1940 and 1941 were 200,000 shares of Commonwealth Edison, 300,000 United Gas Improvement, 100,000 Eastern Airlines, 100,000 Standard Oil of Indiana, 180,000 Consolidated Edison, 500,000 Standard Oil of New Jersey, 250,000 S. H. Kress, 260,000 Pennsylvania Railroad, 200,000 U.S. Steel, and 120,000 Socony-Vacuum. The *Wall Street Journal* estimates that the number of shares distributed by special sales and secondary distributions during the first 7½ months of 1942 exceeded 2,000,000, or about 3 per cent of the total sales on the New York Stock Exchange. Brokers who use these methods of disposing of listed stocks find that they can create an interest in their purchase where none existed before unusual sales methods were used.

The amounts of "special" sales by years from 1941 to 1945, according to the *Commercial and Financial Chronicle*,<sup>1</sup> were as follows:

Year	Amount (Millions)
1941	\$390
1942	131
1943	265
1944	279
1945	446

<sup>1</sup> January 28, 1946, p. 509.

**Listed Bonds.**—While called a stock exchange, the New York Stock Exchange and some of the others deal also in bonds. The smaller exchanges are inclined to confine their interest to stocks. As a matter of fact, the total amount of bonds handled by all the exchanges, other than the New York Stock Exchange and the New York Curb Exchange, is very small. Most bonds are not listed at all. Of those that are listed, a preponderance of sales take place "off the board." This is true in spite of the rules that have been adopted by the New York Stock Exchange to discourage dealings in small amounts of bonds except through the facilities of the Exchange. Again the prices fixed by the open-market dealings through the exchange are used as bases in determining over-the-counter dealings. In quoting bond prices, the unit is a \$1,000 bond. As a consequence, there are no odd-lot transactions in bonds. Because the bond market offers less opportunities to speculators, it is much less active than the stock market. It is probable that many profitable opportunities that exist in bonds are overlooked by speculators who hope for quick profits from their operations. Because transactions in some bonds do not occur every day, those interested in them must limit their information to "bid" and "asked" quotations.

**Making a Market.**—There is another kind of over-the-counter transaction in securities which acts as a substitute for the stock exchange. The over-the-counter dealer may be a member of one or more exchanges. As such, he stands ready to execute orders for his clients, and he charges a commission for this service. In addition, he acts as principal in the purchase of stocks and bonds which he hopes to sell at a profit. Anyone interested in buying or selling unlisted securities may use the facilities of these over-the-counter dealers. Some securities have a sufficiently active market to justify the daily posting of prices which the dealer will pay for them and the prices which he expects to get for them. It is customary for the over-the-counter dealer to keep on file lists of stockholders of some corporations whose securities he deals in, so that he can use them as potential sources of supply of and demand for certain stocks. By keeping in touch with them by various means, he can be ready at all times to serve them. By this means, he literally "makes a market" for unlisted securities. The amount of the spread between the bid and asked prices will depend upon the price level, the risk, and the activity of the market of the particular security. This over-the-counter market is very extensive, involving several thousand dealers scattered throughout the country. Some types of securities are dealt in almost exclusively through these dealers. This is particularly true of government bonds, both those of the national government and municipal bonds, and securities of financial institutions like banks, insurance companies, and some investment companies.

While this kind of an over-the-counter market is a substitute for the security exchange rather than a part of it, it is proper to include a brief

discussion of it at this point because both it and the exchange are subject to regulation by the Securities and Exchange Commission. This regulation forms the subject matter of the next chapter.

### QUESTIONS AND SUGGESTIONS

1. What is meant by marketability? How is it acquired? Give an example of a security with a high degree of marketability and one with only a low degree.
2. What is meant by the collateral value of a security? What kinds of securities can be used most readily for this purpose? Why?
3. What do trends in security prices presume to forecast?
4. What is meant by the listing of securities? How it is accomplished?
5. What are the advantages and the disadvantages of listing securities?
6. What kinds of information are required as a prerequisite to listing?
7. Is it illegal for a corporate official to make a quick-turn profit in speculating in the stock of his corporation? Explain.
8. What is the meaning of manipulation? How is it accomplished?
9. What is a stock pool? Who operates it? Could it be successful if the ordinary security purchasers did not help it along? Explain.
10. Explain margin trading. Do you approve of it? Why? What is the attitude of organized exchanges toward margin trading? Who determines standards for such trading?
11. Explain short selling. What kinds of commodities can be sold short? Why is short selling criticized? How would you defend it?
12. Describe briefly the organization of the New York Stock Exchange.
13. Describe the different types of brokers who operate on the exchanges. How do floor traders operate? Why have they been criticized?
14. Distinguish between "bulls" and "bears." What is the function of the specialist?
15. What is a stop-loss order, and how is it used?
16. Describe odd-lot transactions, and tell how they are consummated.
17. Explain block sales, and tell how they are used. How do they differ from special sales?
18. Are most listed bonds sold through exchanges? Explain. Describe the operation of over-the-counter markets.

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## SUBJECTS FOR INVESTIGATION

1. Review the listing requirements of the New York Stock Exchange and make suggestions for their improvement.
2. From statistics quoted in the *Wall Street Journal*, find out whether short selling of stock is increasing or decreasing and account for any changes that you find.
3. From the *Wall Street Journal* find how many issues of stock are being traded in on the New York Stock Exchange in less than 100-share lots.

## CHAPTER XXV

### REGULATION OF SECURITY EXCHANGES

**Background.**—Disappointed speculators and disillusioned investors are alike in their attitudes toward the regulation of security exchanges. When prices of their securities are going up, they take credit for their own good judgment and want no interference by governmental agencies that will prevent the operation of “natural” economic laws. But when the bears put the bulls to rout and disheartening declines in security prices are recorded day after day and month after month, only those who have sold stocks short can receive any lift from reading the financial pages. The belief in individual good judgment in the selection of stocks which record price increases seldom changes to an admission of poor judgment in buying those which go down in price. Instead, we feel certain that some sinister influence is at work to cheat us. We demand that something be done about it. We insist that the government take steps to prevent a recurrence of such fraudulent practices. It is inconceivable that Congress would have dared to pass the Securities Exchange Act during the bull market of the late 1920's. The lack of effective opposition to such legislation during the depression of the early 1930's is equally understandable.

The unusually severe decline in security prices following the market break in 1929 affected the holdings of millions of people. On the New York Stock Exchange, for example, the total value of listed stocks, computed on the basis of prices as of Sept. 1, 1929, was approximately \$90,000,000,000. Within 2 months a decrease of 20 per cent was experienced. By July 1, 1932, the decline had carried prices down to a computed total of only a little more than \$15,100,000,000, or a drop of more than 80 per cent in less than 3 years. The prices of bonds listed on the New York Stock Exchange fared somewhat better but were still very hard hit. From a high of approximately \$49,300,000,000 on Sept. 1, 1929, they dropped to a low of approximately \$30,500,000,000 on Apr. 1, 1933, a drop of approximately 38 per cent.<sup>1</sup> With this precipitate decline, margins were wiped out and investors and speculators alike were impoverished.

**Nature of Complaints.**—The great mass of losers in stock purchases were bitter but inarticulate. They were resentful against an economic system that permitted their profits and their capital to disappear into thin air. But they did not know whom to blame, how to punish them, or how to prevent

<sup>1</sup> *Senate Report 1455, 73d Congress, 2d Session.*

a repetition of their losses. They had no hope of recovery of amounts already sacrificed. The political sponsors of the discontented security holders rationalized the inarticulate discontent of the masses (1) to draw an indictment against their oppressors, and (2) to propose a remedy. The indictment visualized a stock exchange whose members operated it as a private club for their own benefit. Instead of letting their activities reflect security values made by the balancing of purchase and sale orders, professional traders were accused of manipulating transactions in such manner that they created values or destroyed them as best suited their selfish interests.

Stock-exchange managers boasted that they operated a public institution where investors with a surplus of capital could buy securities and where other investors who needed cash could liquidate their holdings. According to this conception, the function of the speculator was to bridge the gap between the investor-buyer and the investor-seller.<sup>1</sup> But the critics contended that, in the effort to provide liquidity and opportunities for investors to purchase stock in a free market, the speculators became so numerous that they overwhelmed the investors and that the liquidity complex opened the way to fraud, distortion of prices, and the divorcing of security prices from their economic background. Brokers were even accused of using "magic mirrors" by which they could read the cards held by the other players in the speculative game before making their own commitments. It is not our purpose to argue whether or not a knowledge of what is in the minds of outside buyers and sellers can be and has been capitalized to the advantage of stock-market insiders. We are trying to explain the background of the Securities Exchange Act. The core of the whole legislative effort to regulate exchanges can be described in terms of attempts to eliminate the manipulative possibilities of uncontrolled speculation.

**Self-regulation.**—The exchanges themselves had taken successive steps to eliminate the worst of the evils of overspeculation. A study of the steps taken by the managers of the New York Stock Exchange, for example, would disclose numerous actions against members whose conduct brought discredit to the security business. Yet it is probably true that the authority of the Exchange to punish offenders against the public good was neither utilized to the full extent, nor was it extensive enough to prevent abuses that hurt both the legitimate security dealer and his customers. Even some of the administrators of the Securities Exchange Act have professed to believe in the principle of self-regulation. For example, a former chairman of the Securities and Exchange Commission expressed his belief in the following terms:

<sup>1</sup> See Douglas, W. O., "Democracy and Finance" (New Haven: Yale University Press, 1940), Chaps. VIII and IX.

My philosophy was and is that the national securities exchanges should be so organized as to be able to take on the job of policing their members so that it would be unnecessary for the Government to interfere with that business, and that they should demonstrate by action that they were so organized. Now, that is something more than cooperation. That is letting the exchanges take the leadership with Government playing a residual role. Government would keep the shotgun, so to speak, behind the door, loaded, well oiled, cleaned, ready for use but with the hope that it would never have to be used.<sup>1</sup>

As early as 1908, Governor Charles Evans Hughes appointed a committee of the New York legislature to investigate speculation in securities and commodities. The report of this committee pointed to the need for reform in such matters as the size of margins required, corners, manipulative opportunities, and listing requirements. The report leaned in the direction of self-regulation by the New York Stock Exchange, but implied that failure of the Exchange to bring about needed reforms might lead to regulatory action by governmental agencies. The Exchange responded with some changes, and no legislation followed. The first bill to regulate exchanges was introduced in the Congress of the United States in 1914. Strong opposition prevented the bill from being reported out by the Senate committee to which it was referred.

After the severe drop in security prices recorded above, both the House and the Senate conducted hearings on stock-exchange practices. Even before the so-called Pecora investigation was completed, bills were introduced in both houses aimed at abuses in security speculation. Action was finally obtained in an agreement upon a single bill.

**Regulation by Law.**—The Securities Exchange Act became law in 1934. It was substantially amended in 1936 and in 1938. The whole tenor of the law is control of security speculation “in order to protect interstate commerce, the national credit, the Federal taxing power, to protect and make more effective the national banking system and Federal Reserve system, and to ensure the maintenance of fair and honest markets” in security transactions.<sup>2</sup> The law proceeds to recite how these interests are adversely affected by excessive speculation which results in

sudden and unreasonable fluctuations in the prices of securities which (a) cause alternately unreasonable expansion and unreasonable contraction of the volume of credit available for trade, transportation, and industry in interstate commerce, (b) hinder the proper appraisal of the value of securities and thus prevent a fair calculation of taxes owing to the United States and to the several States by owners, buyers, and sellers of securities, and (c) prevent the fair valuation of collateral for bank loans and/or obstruct the effective operation of the national banking system and the Federal Reserve System.

<sup>1</sup> *Ibid.*, p. 82.

<sup>2</sup> The following discussion is based upon an analysis of the Securities Exchange Act, as amended. Direct quotations are taken from the law.



Even economic depressions "are precipitated, intensified, and prolonged by manipulation and sudden and unreasonable fluctuations in security prices."

**Registration of Exchanges.**—Every security exchange whose members wish to make use of the mails or any instrumentality of interstate commerce is required to register with the Securities Exchange Commission. In doing so, it must present information about its organization, rules of procedure, membership, and such other questions as the commission may deem "necessary or appropriate in the public interest or for the protection of investors." Acceptance of registration carries with it an agreement by the exchange to adopt rules that provide for "the expulsion, suspension, or disciplining of a member for conduct or proceedings inconsistent with just and equitable principles of trade." To help carry the expense of supervising the exchanges, an annual registration fee of  $\frac{1}{500}$  of 1 per cent of the aggregate dollar amount of the sales of securities on the exchange during the preceding calendar year is collected by the commission.

**Registration of Securities.**—Only such securities may be bought and sold on a registered exchange as have been duly approved by the exchange, upon filing of an application (a copy of which shall be forwarded to the commission) which contains the following information:

- (A) the organization, financial structure and nature of the business;
- (B) the terms, position, rights, and privileges of the different classes of securities outstanding;
- (C) the terms on which the securities are to be, and during the preceding three years have been, offered to the public or otherwise;
- (D) the directors, officers and underwriters, and each security holder of record holding more than 10 percentum of any class of any equity security of the issuer (other than an exempted security), their remuneration and their interests in the securities of, and their material contracts with, the issuer and any person directly or indirectly controlling or controlled by, or under direct or indirect common control with, the issuer;
- (E) remuneration to others than directors and officers exceeding \$20,000 per annum;
- (F) bonus and profit-sharing arrangements;
- (G) management and service contracts;
- (H) options existing or to be created in respect of these securities;
- (I) balance sheets for not more than the three preceding fiscal years, certified if required by the rules and regulations of the Commission by independent public accountants;
- (J) profit and loss statements for not more than the three preceding fiscal years, certified if required by the rules and regulations of the Commission by independent public accountants; and
- (K) any further financial statements which the Commission may deem necessary or appropriate for the protection of investors.

It will be noted that although these registration requirements are similar to those required under the Securities Act of 1933, these clauses are even more inquisitorial with respect to activities and corporate relationships of key individuals associated with the corporation. Since listing of securities on an exchange is presumed to be an advantage to their owners, delisting of unmatured securities may occur only with the consent of the commission. This consent is usually predicated upon the prior approval of at least the majority of the owners of the stock in question.

**Unlisted Trading Privileges.**—Under the supervision of the commission, numerous stocks are admitted to unlisted trading on registered exchanges. As of June 30, 1945, there were 991 such issues. Of these, 554 were listed on other exchanges, 4 were temporarily exempted from registration, and 433 were not listed on any exchange. This latter group consisted of 386,275,951 shares, or about 14.3 per cent of the total number listed on registered exchanges. During the calendar year 1944, 24,059,373 shares were traded, or about 5.2 per cent of the total share volume dealt in on these exchanges. Of the 433 issues, 102 with 142,597,053 shares were Canadian stocks and American depository receipts for foreign stocks, chiefly British.

As of June 30, 1945, 168 bond issues were admitted to unlisted trading. Of these, 19 were listed on other exchanges; 24 were held to requirements substantially equivalent to those for listing purposes; and the remainder, aggregating over \$1,000,000,000 in principal amount, represented issues that enjoyed unlisted privileges at the time the Securities Exchange Act was passed in 1934. Over the years, the aggregate of both stock and bond issues admitted to unlisted trading has been declining, as was anticipated when the act was passed.

**Segregation of Functions.**—One of the most discussed features of security trading is the scope of activities of exchange members. The floor trader in particular was singled out for attack. An original draft of the bill that became the Securities Exchange Act provided that a member might be a broker or a floor trader but that he could not serve both functions. The law as finally enacted gave to the commission the power to restrict or to prohibit the activities of specialists, odd-lot dealers, and floor traders. After an investigation of the question, the commission recommended against legislation that would result in a complete segregation of broker and floor-trader functions. It did, however, recommend that the activities of the specialist be limited in such manner that all his dealings be fully margined at all times. It requires also that discretionary orders are not to be executed by specialists but that all of them must be "limited" or "market" orders. Also, when a specialist executes an order, he must disclose to his customer, in writing, whether he is acting for himself or for someone else. The commission is continuing its study of segregation of member functions to the

end that effective means may be found to prohibit the possessor of "inside" information from taking advantage of those who lack such information.

In January, 1945, the trading and exchange division of the commission recommended the prohibition of floor trading on the New York Stock Exchange and the New York Curb. After conferences with interested parties and after the review of evidence filed in opposition to this proposal, the commission deferred action with the warning that "If at any time it becomes evident to us that the Exchanges' rules, either in the form now proposed, or as they may be modified, are inadequate for the effective regulation of floor trading, we shall . . . take such action as, in our opinion, will provide an adequate solution of the problems created by floor trading."

**Manipulation.**—Manipulation consists of the various activities engaged in by individuals or groups for the purpose of influencing the increase or the decrease of security prices, as best suits their purposes at the moment. It represents an artificial method of producing price fluctuations which may accentuate, or even run contrary to, more basic causes of changes in security values. It is not surprising, therefore, that Congress was particularly concerned about taking steps to eliminate or at least to minimize opportunities for manipulation. The methods used were two. Some practices are declared by the Securities Exchange Act to be illegal. Among them are the following: Wash sales, which are not really sales at all since no actual payment or delivery is intended; matched orders, given by the same individual for the purpose of having the ticker tape show activity in the stock; pool operations; "touting" a stock by passing out tips to the effect that market operations are about to result in a rise or decline in the price of the stock; and the dissemination of false or misleading information.

The second method of discouraging manipulation was to give the commission the power to regulate practices that might facilitate manipulation. These include transactions intended to "peg" or stabilize the prices of stocks; trading in options or privileges such as puts, calls, and straddles; short sales; stop-loss orders; and any other device that might facilitate the plans of individuals or groups interested in causing security prices to go up or down. With respect to short selling, for example, the commission has ruled that short sales may not be made below the price of the last regular sale on the exchange and not even then unless such price is above the next preceding different price at which a regular sale was effected. This rule is intended to prevent "bear raids," which are associated with successively lower price quotations. The law prohibits short sales by officers, directors, and stockholders who hold more than 10 per cent of the corporation's stock.

The Securities Exchange Commission is engaged constantly in efforts to discourage manipulation of security prices. According to its "Tenth Annual

Report," it surveys price movements of 3,500 securities listed on exchanges and an additional 2,500 securities traded in over the counter. It watches not only price changes but "news items, earnings figures, dividends, options, and other data which might explain price and volume changes." When no plausible reason is present to explain unusual changes, "flying quizzes" are instituted to find out why and to discourage manipulation, preferably before it really gets started. During the 10 years ending June 30, 1944, the commission conducted 1,137 "flying quizzes."

**Margin Trading.**—Like short selling, margin trading is looked upon with suspicion in many quarters. It is closely associated with manipulation in the thinking of its opponents. The Securities Exchange Act gave the Federal Reserve Board the power to pass rules and regulations governing margin trading "to prevent the excessive use of credit for the purchasing or carrying of or trading in securities." The reason for this provision was not to further the plans of the speculator, but

to prevent a recurrence of the pre-crash situation where funds which would otherwise have been available at normal interest rates for uses of local commerce, industry, and agriculture, were drained off for higher rates into security loans and the New York call market. Increasing margins—*i. e.*, decreasing the amounts which brokers or banks may lend for the speculative purchase and carrying of stocks—is the most direct and most effective method of discouraging an abnormal attraction of funds into the stock market.<sup>1</sup>

The law prescribed that the initial amount of credit that may be extended for the carrying of securities shall not be greater than the larger of the following amounts: 55 per cent of the market price of the security, or 100 per cent of the lowest market price for the preceding 3 years but not more than 75 per cent of the current market price. Thereafter the Federal Reserve Board is authorized to prescribe such lower margins "as it deems necessary or appropriate for the accommodation of commerce and industry"; and such higher margins "as it may deem necessary or appropriate to prevent the excessive use of credit to finance transactions in securities." Acting under this security, the Federal Reserve Board has since lowered margin requirements to 40 per cent of the current market price of the securities against which loans are made, and has subsequently raised margins successively to 100 per cent.

**Restrictions upon Borrowing.**—With respect to the borrowing capacities of exchange members and brokers who deal through an exchange, the act provides that they may not borrow except from or through a member of the Federal Reserve system or from a nonmember which adheres to the Reserve's rules governing the financing of security transactions. This means that no funds can flow into the securities markets except with the knowledge and

<sup>1</sup>House of Representatives, *Report 1383*, 73d Congress, 2d Session, p. 8.

consent of the Federal Reserve Board. To protect customers from over-borrowing by brokers, the law provides that the board shall set the maximum limits on the total indebtedness of brokers; but in no event may the limits so set exceed twenty times the net capital of the broker employed in the business, exclusive of his fixed assets and the value of his exchange membership. Finally, brokers are not permitted to lend securities that they carry for their customers without the latter's written consent. In the drafting of rules to make this section of the act effective, the commission has provided that the securities of several customers may not be commingled without the consent of all, that a broker must not commingle customers' securities with his own, and that a broker must not pledge a customer's securities for more than the customer's indebtedness to him.

**Proxies.**—The commission is empowered to establish rules and regulations governing the solicitation of proxies through the use of the mails or of any instrumentality of interstate commerce and the granting of proxies by brokers who hold stock for their customers. The rules that have been adopted have as their purpose more intelligent action by stockholders in the granting of proxies. The solicitor must indicate the extent of the interest that he or any officer or director may have in any question to be acted upon at the meeting. Concerning questions to be submitted for action at the meeting for which the proxy is solicited, various types of information must be submitted with the request for the proxy, depending upon the nature of the issues. Rules have been adopted concerning the kind of information that must accompany requests for proxies when questions like the following are to be determined: election of directors; remuneration of officers, directors, and employees; amendments to certificate of incorporation and bylaws; issuance of or changes in securities; mergers, consolidations, and liquidation; changes in accounting practices.

Any stockholder interested in soliciting proxies on his own account may obtain from the corporation the number of stockholders and the approximate cost of soliciting their proxies. If the stockholder so requests, the corporation must send out his request for proxies together with any proper statement he may care to make to the stockholders, provided he pays the cost of preparation and distribution.

In general, it is the hope of the commission that its administration of proxy regulations may aid in restoring democratic processes in the control of corporations by their owners. In taking steps to aid the recipient of the proxy to take intelligent action in protecting his own interests, the commission hopes to encourage the use of proxies to that end. This is a laudable purpose. It will be interesting to see further evidence of its operation. At the outset, the initiative at least rests with the management. During the year ended June 30, 1944, the commission examined the "preliminary and definitive" material with respect to 1,501 proxy solicitations: 1,472 were

made by the management and only 29 by security holders not a part of the management group. During the year ended June 30, 1945, 1,630 solicitations were examined.

**Gains from Inside Information.**—In addition to the prohibition of short sales by officers, directors, and stockholders who own more than 10 per cent of a corporation's stock, other means are employed to prevent insiders from taking unfair advantage through the use of information possessed exclusively by them. Every such person must file with the commission a statement of the amount of the corporation's stock owned by him. Thereafter, monthly reports of changes in ownership are required. If any profits are made from such purchases and sales within any period of 6 months, the corporation, or any stockholder acting in its behalf, may sue to recover it for the corporation. Such a provision is intended to curtail short-term speculation by members of the inside group who might use their inside information for selfish purposes. That this provision of the law has not stopped trading in securities by insiders is evidenced from the fact that, during the first eleven years experience with it, more than 230,000 reports have been filed by more than 37,000 persons subject to its requirements.

**Reports.**—The information filed by a corporation whose securities are listed on a registered exchange is to be kept up to date by the filing of such supplementary quarterly and annual reports as may be required by the commission. In order to make sure that this periodic information serves its purposes, the commission may prescribe the form in which it is to be submitted, including the accounting procedures used in the preparation of reports. Some corporate officials feel that the publication of the information filed with the commission might be used by their competitors in a manner to injure its authors. When the reports are filed, requests may be made that their contents be withheld from publication. Thereafter the commission is expected to withhold disclosure of this information, except when it thinks the public interest would be served best by disclosure.

Opponents of public disclosure of information filed with the commission sometimes take the position made famous by Commodore Vanderbilt when he considered the affairs of a business corporation private. The English have pretty well exploded this theory in their distinction between a private or closely owned corporation and a public corporation which obtains its capital from the investing public. Whenever a business enterprise sells its stocks and bonds in the open market made possible by a securities exchange, the claim to privacy is not very convincing. The only way in which a prospective purchaser can hope to act intelligently is by using information that should be made available to him. Both the Securities Act of 1933 and the Securities Exchange Act of 1934 place great emphasis upon making adequate and truthful statements about corporate affairs available currently to interested parties.

**Over-the-counter Markets.**—It is conceivable at least that if the Securities Exchange Act of 1934 had not been amended some securities listed on regulated exchanges would have been withdrawn from listing. Thereafter they would have been dealt in over the counter to avoid supervision by the commission. To prevent this, the Act of 1934 was substantially amended in 1936 and again in 1938. Even without the possibility of efforts to evade this law in the manner indicated, the over-the-counter market is an extensive one. It includes most of the original flotation of stocks and bonds. The number of issues of securities bought and sold over the counter far exceeds those dealt in on all the exchanges. The number of dealers is larger than the membership of the exchanges. In 1938, for example, there were nearly 7,000 over-the-counter brokerage houses registered with the commission. The maximum membership on the New York Stock Exchange is only 1,375.

All over-the-counter dealers who use the mails or any instrumentality of interstate commerce are required to register with the commission. The commission may deny any application for registration and revoke any registration if it finds that such denial or revocation is in the public interest. All applications must be denied if the applicant or his partner or his branch manager has willfully falsified a material fact in making the application, has been convicted of a crime involving the business of brokerage, has been enjoined by a court in connection with security transactions, or has willfully violated the Securities Act or the Securities Exchange Act.

By the passage of the Maloney Act in 1938, the Securities Exchange Act was further amended to provide for the organization of national associations of security dealers and for their registration with the commission. The purpose of such associations is to assist in the regulation of over-the-counter markets. Previous to the passage of the Maloney Act, over-the-counter dealers had no effective means of disciplining their competitors who dealt unfairly with their customers. The organization of dealer associations, it was hoped, would provide for the over-the-counter dealers something like the machinery already in use by the stock exchanges in keeping their members in line. The application for registration must be accompanied by copies of their constitutions and by-laws which must meet the approval of the commission. The rules of the association must be

designed to prevent manipulative acts and practices, to promote just and equitable principles of trade, to provide safeguards against unreasonable profits or unreasonable rates of commission or other charges, and, in general, to protect investors and the public interest, and to remove impediments to and perfect the mechanism of a free and open market; and are not designed to permit unfair discrimination between customers or issuers, or brokers or dealers, to fix minimum profits, to impose any schedule of prices, or to impose any schedule or fix minimum rates of commissions, allowances, discounts, or other charges.

As of June 30, 1944, according to the "Tenth Annual Report" of the Securities and Exchange Commission, only one such association was in existence. It was the National Association of Securities Dealers, Inc., with a membership fluctuating from 1,500 in 1939 to 3,000 in 1941 and to 2,100 in 1944. This represented slightly less than half of the 4,323 over-the-counter brokers registered with the commission as of the latter date. The commission's report details the various ways this association cooperates in the supervision of the over-the-counter market. The membership of the National Association of Securities Dealers, Inc., as of June 30, 1945, was 2290.

**Special Offerings.**—At the request of organized exchanges, the commission took cognizance of the special offerings and block sales described in the previous chapter. The plan submitted by the exchanges and approved by the commission encourages the sale of large blocks of stock to be effected through the exchanges. As a consequence, from Feb. 19, 1942 to June 30, 1944, a total of 182 offerings involving 2,325,582 shares of stock having a value of \$68,406,000 was effected through the New York Stock Exchange. During the same period, 23 special offerings involving 141,253 shares of stock having a value of \$2,019,000 were effected on other exchanges.

**Administration.**—The administration of the Securities Exchange Act is in the hands of the Securities and Exchange Commission, consisting of five members appointed by the President of the United States and confirmed by the Senate. Like most commissions of this kind, not more than three members may be members of the same political party. All must devote their full time to the work of the commission and no member may participate, directly or indirectly, "in any stock-market operations or transactions of a character subject to regulation by the Commission." In addition to the Securities Exchange Act, the commission administers the Securities Act, the Public Utility Holding Company Act, the Trust Indenture Act, the Investment Company Act, and the Investment Advisers Act. In addition, it performs various functions in connection with corporate reorganizations. The work of the commission is distributed among nine major divisions whose functions correspond to the major divisions of the legislation named above.

In the administration of the Securities Exchange Act, the commission is supported by the possibilities of both civil and criminal liabilities. Willful violation of any provision of the act or proper rule of the commission may result in both fine and imprisonment for the offender. Civil liability runs in favor of an injured party who suffers a loss in acting upon false or misleading information and against the party who is responsible for the statement. On its own initiative, the commission may investigate violations of the act. The commission classifies its investigations into three groups: flying quizzes which are quick, informal surveys to determine if more formal



proceedings are needed; preliminary investigations; and formal investigations. The commission's investigations for the year ended June 30, 1945, are shown in the following table:

TRADING INVESTIGATIONS

	Flying quizzes	Informal investigations	Formal investigations
Pending June 30, 1944.....	59	...	19
Initiated July 1, 1944, to June 30, 1945.....	306	5	14
Total .....	365	5	33
Changed to informal case or formal investigation.....	15	2	
Closed or completed.....	187	...	5
Total disposed of.....	202	2	5
Pending June 30, 1945.....	163	3	28

On the evidence discovered in this manner or by complaint of injured parties, it may enjoin threatened violations of the act, or it may sue to enforce compliance with it. Where the act or any rules or regulations of the commissions are violated, the commission may suspend or withdraw the registration of an exchange, withdraw the approval of any security, or suspend or expel any member from an exchange.

Without going so far as any of the foregoing penalties imply, the commission may direct that trading in any specific security be suspended for a period not to exceed 10 days. It may "suspend unlisted trading privileges in whole or in part for any and all classes of securities for a period not to exceed one year, if it deems such suspension necessary or appropriate in the public interest." With the approval of the President of the United States, it may suspend trading on any exchange for a period of 90 days. It may request changes in the rules of any exchange. If they are not made voluntarily, the commission may change or add to the rules of any exchange whenever such changes "are necessary or appropriate for the protection of investors or to insure fair dealing in securities traded in upon such exchange or to insure fair administration of such exchange."

**Appraisal.**—The success of any such agency as the Securities and Exchange Commission depends upon the relationship it is able to establish with those who are responsible for the operation of the activities supervised. Governmental supervision of any business attains its highest degree of success in an atmosphere of mutual trust. Where mutual distrust exists, the supervising authority is likely to develop witch-hunting tendencies;

while those who are supervised are invited to spend too much time and energy in developing defensive security. Under these circumstances, supervision becomes increasingly difficult while at the same time it becomes decreasingly effective.

The chairman of any commission like the Securities and Exchange Commission naturally gives it color. While he may not always dominate its decisions, the public looks to him to define the attitude and the scope of his commission's activities. During the first twelve years after the passage of the Securities Exchange Act, the commission had seven different chairmen, only the first and seventh of whom had had previous experience in dealing with the problems of security markets. As is to be expected, the reaction of the members of firms engaged in the business of dealing in securities toward these different chairmen varied considerably. Unquestionably, the nature of the securities business has undergone drastic changes since 1929, due in part to the work of the commission and in part to the operation of fundamental economic principles. While there have been legitimate criticisms directed at particular decisions of the commission, the net result of its work has certainly added protection to the security buyer. Regardless of political changes that may occur, we are not likely to abandon the Securities and Exchange Commission and its activities.

#### QUESTIONS AND SUGGESTIONS

1. Describe briefly the background of the Securities Exchange Act.
2. How severe were the security price declines after the crash of 1929? What kinds of complaints were registered as a result of this decline?
3. What is the function of the professional speculator?
4. What is meant by self-regulation? How effective has it been?
5. What was the purpose of the Pecora investigation? What is the legal justification for Federal regulation of security exchanges?
6. What are the purposes of registration of exchanges? What kinds of information must be submitted with applications for the registration of securities?
7. What is the meaning of delisting of securities? How can it be accomplished?
8. Describe unlisted trading privileges.
9. Why should there be criticisms of floor traders acting also as brokers? What is a discretionary order, and why is it opposed?
10. Why should the Securities and Exchange Commission be concerned with the subject of manipulation? What steps have been taken to prevent it?
11. Why are short sales by officers and directors prohibited? How can this regulation be evaded?
12. What are the functions of flying quizzes?
13. Why is margin trading discouraged? How is this accomplished?
14. Why are restrictions upon borrowing by brokers a matter of concern to the Federal government?
15. What authority has the Securities and Exchange Commission over proxies? What kinds of information are disclosed? How can any stockholder solicit proxies for himself?
16. Why is the disclosure of information filed with the commission opposed?

17. How does the commission regulate over-the-counter markets?
18. What are the purposes of the Maloney Act?
19. Who administers the Securities Exchange Act? What are their legal qualifications?
20. What powers of enforcement does the Securities and Exchange Commission possess?

#### SUPPLEMENTARY READINGS

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#### SUBJECTS FOR INVESTIGATION

1. Review the latest annual report of the Securities and Exchange Commission, and summarize its work during the past year in regulating security exchanges.

## PART IV

# INTERNAL FINANCIAL CONTROL

### CHAPTER XXVI

#### ORGANIZATION FOR FINANCIAL CONTROL

**Approach.**—In the preceding chapters, we have dealt with the concept of the corporation, the kinds of securities commonly used to secure capital, the promotion of corporations, and the means used to sell securities to the investing public. Formerly, these chapters constituted the chief content of what was then considered corporation finance. A thorough understanding of them is essential, whether from the viewpoint of the manager of a corporation or of the purchaser of its securities. But the essence of business success is not in the raising of capital. Rather it lies in the use that is made of it after it has been accumulated.

The relationships that have been considered to date may be classed under a general head designated as external. We have dealt with the relationship of the corporation to the state that grants its charter, to the governmental agents that regulate the sale of its securities, to those who market these securities, and to the investors who supply its capital. In the chapters that follow immediately, we plan to discuss internal relationships of a financial character. While, for the most part, financial policies are planned and executed by corporate managements without consulting stockholders or bondholders, their success or failure means profit or loss to those with a financial stake in the enterprise. Again, therefore, both from the point of view of the investor and the person concerned with or interested in corporate management, an understanding of internal policies and their administration is essential.

**Unmanaged Business.**—Analysis of the results of many business operations discloses a deplorable lack of the application of foresight so necessary to business success. Business leaders are usually credited with a sort of sixth sense not possessed by other people. We think of them as being able to steer clear of the rocks that wreck the fortunes of amateur navigators in the business seas. The test of business leadership is not always the delivery of the ship at the proper port. Favorable winds and the absence of storms may be the causes of the successful voyage. The next venture may not result so successfully unless the navigator possesses something more than good luck.

Many businesses, even those that attain a measure of success, at least for a time, may be characterized as unmanaged. On the upturn of the business cycle, with a growing demand for products at increasing prices, many businesses succeed in spite of their managers rather than because of them. Such enterprises drift along, impelled by favorable winds and currents, so long as the business weather is favorable. The real test of business leadership is the ability to ride out a storm and dock the ship safely in the face of adverse conditions. Measured by this test, many enterprises flounder and sink at the hands of incompetent helmsmen. In reality, they are unmanaged businesses.

In the chapters that dealt with control over the issuance of corporate securities by governmental agencies, nothing was said about the efficient use of capital, once it was obtained by a corporation. As was pointed out in those chapters, regulatory agencies are primarily interested in preventing fraud. No one has yet devised a plan for policing the operations of a business in such a manner that mistakes in judgment can be prevented. This is a matter that the management only is responsible for. That is the reason why it is so necessary that system shall be introduced in the planning of business policies to avoid the consequences of unmanaged business operations. While the emphasis upon planning should dominate all business operations, the particular policies dealt with in the following chapters will be confined to those of a distinctly financial nature. This does not suggest that the acquisition and utilization of labor and material, for example, is not important to financial policies—quite the contrary. Nevertheless, our primary concern is with the efficient use of the financial resources available to the managers of the business.

**Meaning of Financial Control.**—Capital is but one of the factors necessary for business success. It is always a passive factor. Its use must be directed. This direction constitutes financial control. It includes not only the acquisition of capital in the proper amounts, at the right times, and under favorable conditions, but the careful and constant control of the investment and use of capital and the disposition of the profits arising therefrom. "Capital" is used here in the broad sense, to include current as well as fixed assets. At times, the acquisition of capital is surprisingly easy. Its efficient use is more difficult. Indeed, the supply of capital becomes so great on occasion that amateurs easily secure the rights to use it, much to the later sorrow of the owners thereof. Even competent managers find the capital market so glutted that they employ capital inefficiently because it is so easy to obtain. Under such circumstances, financial control drops its guard, and the business enterprise receives a staggering blow which could have been avoided had less optimism dominated the management.

**Forecasting.**—Forecasting business conditions is not quite the popular indoor sport that it once was. Professional forecasters, especially, have

lost their punch. In fact, the only popular forecaster ever was the chap who predicted favorable conditions, and even he was thrown overboard as soon as his prophecies failed to materialize. And yet, in spite of all the prophetic failures of recent years, business must forecast. "Tit-tat-toe, 'round I go" is never a safe rule for business to follow. The two outstanding characteristics of business operations are (1) the dynamic nature of business relationships, and (2) the need for constant alertness to anticipate and make provision for changes. Forms of business enterprise, methods of production, demand for products, methods of financing, governmental relationships—all are in a constant state of flux. New concentration centers may form at any point and at any time. Business leaders must keep a weather eye on barometers and seek to interpret changing pressures. There is no alternative: business leaders must make continuous forecasts. Furthermore, they must base their actions on their forecasts and stand ready to take the credit or the blame for their decisions.

While forecasting has always been necessary to ensure the success of any business venture, its use in the future will be even more significant than in the past. The increasing complexities of economic relationships, together with the unpredictable character of frequent changes in consumer demands, place upon business managers a kind of burden that their predecessors were not asked to bear. Even governmental relationships, including their propensity to place ever-increasing tax burdens on business operations, complicate business policies in ways that make forecasting more difficult than ever without, however, eliminating the necessity for such forecasting. The relationship of forecasting and budgeting will be discussed later in this chapter.

**Forecasting Services.**—Business leaders are not wholly dependent upon their own resources in attempting to forecast future business conditions. There are a variety of agencies that undertake to forecast future conditions and to make the results of their studies available to all who are interested in them. Some such services are incidental to other services rendered to the public. A bank, for example, may publish regularly the results of the studies of its research staff. A trade association may try to keep its members informed about probable future events that may affect their plans. Other services are organized primarily for forecasting purposes and sell their opinions in the form of regular publications for an annual or other fee.

In general, there are three types of forecasting services, measured in terms of the scope of their coverage. Some attempt to cover the conditions of a single industry only. The *Iron Age* publishes a weekly index of steel production, and *Printers' Ink* publishes monthly advertising expenditures. A second group deals with general business conditions such as indices of prices, wages, security prices, and carloadings. Several of these send weekly reports to their subscribers. Among the better known services in this class

are Standard and Poors and Moody. Because of the importance of governmental actions that affect business, a number of weekly services, like the *Kiplinger Washington Letter*, go out to their subscribers with an analysis of the probable effect of laws and other governmental actions upon business. A third group of services merely summarize what other forecasters say. These may be more or less formalized, or they may be more informal presentations in the press and on the radio.

**Indices Used in Forecasting.**—Among the most commonly used indices in forecasting business conditions are the following:<sup>1</sup>

PRODUCTION INDICES	
Steel-ingot operation (percentage of capacity)	Building and construction (public and private)
Automobile production	Electric-power production
TRADE INDICES	
Carloadings	Inventories of manufacturers, wholesalers, retailers
Department-store sales	Value of imports and exports
Check payments	
FINANCIAL INDICES	
Stock and bond prices	Prices of basic commodities
Commercial bank loans	Wholesale prices of agricultural products
New capital issues	Retail prices of same
Interest rates on commercial borrowings	Foreign-exchange rates
Business failures	
OTHER FACTORS	
Government policies affecting business	Wage rates
Government financial situation	Relations between capital and labor
Employment (or unemployment)	Foreign affairs

**The Financial Department.**—From what was said in earlier chapters, it is evident that the responsibility for financial policies rests upon the board of directors, the policy-making arm of the corporation. In American experience this usually means that financial policies are initiated by the officers, who submit their recommendations to the directors for approval. The acceptance, or modification, or even the rejection of such recommendations makes the directors responsible for the decisions involving financial policies. The execution of these policies is delegated to those employed in the financial department of the corporation. The two officers most directly concerned with the operation of this department are the treasurer and the controller. Many corporations do not employ an officer whose title is designated as controller. In his absence, the treasurer most often exercises his functions. Where there is a controller present, some of the treasurer's duties may be delegated to

<sup>1</sup>MacDonald, John H., "Practical Budget Procedure" (New York: Prentice-Hall, Inc., 1939), p. 27.

the controller. In the discussion that follows, we are much more concerned with functions than we are with their allocation to any particular officer. Both the treasurer and the controller look in one direction to the board of directors, to whom they are directly responsible, and in the other direction to various other officers and department heads, from whom they must expect a large measure of cooperation in carrying out the financial program entrusted to their administration.

**Duties of Treasurer.**—The duties of the treasurer vary with the nature of the business, the size of the enterprise, and the kind of organization under which it is operated. In some cases, the president is in charge of the financial department while the treasurer is only a cashier. In other cases, the treasurer has responsibility over accounting, statistical, and other departments as well as the financial department. Because of this wide variation in duties, the discussion that follows is confined to the head of the financial department only, regardless of the title he carries. The source of the duties of the treasurer may be the state statutes, covering the filing of annual reports, etc.; the by-laws or other regulations of the corporation; the resolutions and general orders of the board of directors; and the delegation of duties by the president or chief executive of the corporation. The chief duties of the treasurer may be enumerated as follows:

1. To have custody of the corporation's funds and securities.
2. To keep records of corporate transactions.
3. To accept all payments to the corporation and to deposit all receipts in the name of the corporation.
4. To honor all expenditures properly authorized and to pay out the corporation's money in satisfaction thereof.
5. To supervise the finances of the corporation. He may share this duty with the president or other officer designated by the board of directors.
6. To endorse all negotiable instruments of the corporation.
7. To make financial reports to the state, to the board of directors, and to the stockholders.

He is usually required to give bond to ensure the faithful performance of his duties. Since he is directly responsible to the board of directors, his records are open to their inspection at all times. In addition to the above duties, he sometimes has charge of credits and collections. Whether or not he supervises the work directly, he should be consulted in the determination of credit policies.

**Treasurer's Reports.**—In smaller corporations, the treasurer is usually a member of the board of directors and keeps in constant touch with the other members. By informal conversations, he keeps them informed of the financial affairs of the corporation. In larger corporations, whose boards of directors hold regular, formal meetings, more formal treasurer's reports are required. Monthly income statements and quarterly balance sheets are



common. Since the directors are responsible for the management of the corporation but dependent for their information upon the officers, the treasurer should make full and frank reports to them. With the consent of the board, detailed reports may be limited to the finance committee. If monthly income statements and quarterly balance sheets are not feasible, they should be presented as frequently as possible. Annual reports are always expected.

Reports to stockholders are not so frequent or so complete as those rendered to finance committees and boards of directors. The fear of use of such reports by competitors is the usual excuse offered in justification of meager and infrequent reports to stockholders. This may be plausible in some cases. As a general rule, the stockholders are entitled to more information than they are accustomed to receive. The report to the stockholders is usually embodied in the president's report and may be "editorially" interpreted by the latter.

**Liabilities of Treasurer.**—As custodian of the corporate funds, the treasurer occupies a position of peculiar responsibility to the corporation. It is necessary to outline rather carefully the liabilities that he assumes. They are as follows:

1. *Neglect of Duty.*—If, for example, funds are stolen through the neglect of the treasurer, he may be held liable for the loss. If he fails to make reports required of him by the board of directors, he may be held liable for losses resulting therefrom. In case of loss to the corporation due to his neglect, his bond may be forfeited.

2. *Faulty Performance.*—If the treasurer performs any duty improperly, he may be held liable to the corporation. For instance, losses resulting from payment of funds without proper authorization may result in his personal liability for the loss.

3. *Unauthorized Acts.*—The treasurer's duties are ordinarily well defined. Should he act entirely outside his line of duty, he may be held liable by the person who suffers loss through his unauthorized acts.

4. *Illegal Acts.*—The illegal acts of a treasurer for which he may be held liable usually involve fraud. They may include embezzlement as well. Whether acting for his own benefit or that of the corporation, the treasurer may be held liable to the party injured and may, in addition, be prosecuted for criminal acts.

**Relationship to Others.**—The treasurer is usually directly responsible to the board of directors. The latter are governed in their discretion by any charter or by-law provisions defining the duties and obligations of the treasurer. Individual directors have no authority but must act collectively. The treasurer is not directly responsible to the stockholders and is not subject to orders from them. The treasurer is required, by the nature of his office, to work with other officers and department heads. He may, as already indicated, supervise some of the other departments. He is expected to work

harmoniously with the president of the corporation but should not be under his direction. The financial affairs of the corporation are so important that the directing head thereof should always be directly responsible to the board of directors.

**The Finance Committee.**—Large corporations, with unwieldy boards of directors, delegate much of the financial management of the corporation to the finance committee. While nominally a committee of the board of directors and responsible to it, the finance committee's decisions are usually approved *pro forma* by the board. If the treasurer is a director, he is also, *ex officio*, a member of the finance committee. If he has definite financial ability, he may dominate the committee and, in effect, determine the financial policies of the corporation. If he is not a director, he cannot be a member of the finance committee but is expected to work closely with it. Even though not a member, he may use his ability to determine financial policies for the corporation. In other words, an able treasurer makes financial plans and asks the finance committee or the board of directors for their formal approval. A less able treasurer is expected to supply the committee or the board with information upon which to base their decisions. In form at least, the treasurer receives much of his authority from the finance committee. In 1935, General Motors replaced its finance and executive committees with an administration committee to "have complete charge of the administration of business and, in collaboration with the policy committee, the development of forward operating policies."

**The Controller.**—Financial policies and forecasts are necessarily based upon information obtained largely from the accounting and statistical records of the corporation. Such information must be properly arranged, analyzed, and interpreted if sound judgments are to be based thereupon. This is the work of the controller, whatever be the title of the person who performs it. He obtains his information from the financial, accounting, sales, production, and other departments. His interest differs from that of the heads of these departments. For that reason, he may make new combinations of reports in order that analysis and interpretation may be facilitated. In this manner, the controller is related in his work not only to the financial department, but to all other departments of the business. He may be in position to advise department heads concerning their own work. In turn, he is constantly dependent upon every one in the corporation able to furnish him with information upon which future policies may be based.

In some cases, the controller plays a larger part in financial planning than does the treasurer. He may not only collect, analyze, and interpret the information, but he may be given considerable part in drawing conclusions therefrom. In such cases, the treasurer's function is limited in this respect to the execution of the program.

**The Secretary.**—There is little opportunity for conflict between the duties of the treasurer and those of the secretary. These two officials should work harmoniously: As a matter of fact, in the smaller corporations the same individual frequently fills both offices.

### BUDGETS

**Definition.**—Someone has defined budgeting as “doing your worrying in advance.” It is a process of matching outgo with anticipated income. It attempts to establish standards of expenditure for a specified future period in terms of the business needs of the period as forecasted in advance. There is no standardized plan of budgeting applicable to all kinds of businesses. Nor should any budget be used other than as a guide to business operations. Neither corporations nor individuals were ever intended to be slaves to an artificial set of rules that no longer apply to changed conditions. The financial budget of a business corporation is intended to accomplish two definite purposes: (1) to supply the management with a means of control over financial expenditures, by planning them in advance to correspond with the estimate of current and prospective outlays of the corporation; and (2) to center the attention of department heads, whose reports form the basis of the estimates, upon the probable financial programs and the reasons therefor.

**Origin.**—Every person responsible for the expenditure of funds makes some application of budgetary principles. Formal application was first confined to the financing of municipal government, where outgo very early tended to exceed income. Emphasis upon business budgeting received great impetus after the First World War, when the rush to produce at any cost subsided and the need for more definite attention to costs became apparent. Serious attempts to determine costs uncovered wasteful methods. Efforts to control them naturally followed. Since then we have heard much of production, distribution, administrative, and financial budgets.<sup>1</sup>

**Forecasting and Budgeting.**—Forecasting attempts (1) to anticipate external economic and trade changes, and (2) to furnish the basis for adjusting the operations of the corporation to such anticipated changes. Faith in forecasting agencies will color the belief in the accuracy of estimating scales of future business operations. The weaknesses of forecasting agencies and the paucity of information used by them are recognized. Nevertheless business operations must be fitted to some pattern and must be planned in advance. The pattern is the forecast. Planning of operations to fit the pattern constitutes budgeting. The pattern is determined in large part by external conditions, such as probable demand for goods, conditions

<sup>1</sup> Rogers, D. M., Development of the Modern Business Budget, *Journal of Accountancy*, March, 1932, pp. 186-205.

of the money market, unusual circumstances such as the uncertainties of war, etc. Planning of operations to fit a pattern is a matter of internal control. The management of a corporation controls budget making; it cannot control the conditions upon which the budget is based.

**Budgeting and the Business Unit.**—When small business units produced simple products whose period of manufacturing was short, a high degree of flexibility permitted day-to-day decisions. Budgeting operations for months in advance were unnecessary. One-man control permitted quick decisions, and the small scale of operations facilitated their execution. Large-scale business units and roundabout processes of production result in rigidity, which dictates the organization of standards of operation to govern operations for months in advance. Large construction projects must be planned years in advance. It takes time to start or to stop modern productive machinery. If the fears that dominate business managers during depressions should dissolve overnight, it would take considerable time for their new-found courage to express itself in full-time plant-capacity operations. Labor supply must be recruited, raw materials collected, machinery repaired, and a re-formed organization developed to an efficient level. In the same manner, a decrease in orders is not immediately followed by a shutdown or even a slowing down of operations. Large bodies move slowly. The larger the size of the business unit, the greater the need for standardization and for determining, in advance, the scale of operations to be adopted for any given period.

**A Coordinating Process.**—Budgeting is not merely a process of determining in advance expenditures for the whole business unit. It is largely a means of determining in advance how departments of the business will aid the plans of other departments. An advertising campaign which creates a demand for products that the production department cannot supply is not a good example of proper planning for the future. The budget must dovetail the work of separate departments in such manner that the collective goal may be reached without a hitch. The coordinating process assumes proper timing of each step. If production consumes 4 months' time, it is useless to plan a sales campaign based upon 30-day delivery. If construction made necessary by an expansion program cannot be made available within less than a year, it would be wasteful to order raw material for use therein to be delivered in 60 days. This need for coordination is the very heart of a budgeting program calls for a high degree of cooperation among the various departments of the business.

**Advantages of Budgets.**—One of the earliest and still one of the best summaries of the advantages of the use of budgets in a business enterprise is that published by Ernst and Ernst in 1925 under the title "Budget Control, What It Does and How to Do It." These advantages are summarized as follows:

1. It has a marked influence on the most economical use of working capital, since it is planned to make maximum use of plant facilities and current assets.

2. It prevents waste, since it regulates the spending of money for a definite purpose and in accordance with appropriations established by the executives of the business.

3. It places definitely—just where it belongs—the responsibility for each function of the business.

4. It makes for coordination. It compels all departments of a business to cooperate in attaining the results fixed by the budget.

5. It presents in cold figures the best judgment of executives committed to a definite business objective, thus guarding against undue optimism which often leads to overexpansion.

6. It acts as a safety signal for management, since it indicates the variance between estimates and the actual results obtained. Thus, it shows when to proceed cautiously, as well as when manufacturing or merchandising expansion may be safely undertaken. It is an automatic check on the judgment of the executives—a check frequently revealing losses in time to stop the waste.

7. It is the most potent force in business for the conservation of the resources of business, since it regulates the spending of money within the confines of income.

8. It is invaluable to management in determining the effects of sales, production and financial policies.

9. It compels management to study its markets, products, methods and service, thus disclosing ways and means for strengthening and enlarging the business.

10. It compels management to study and to plan for the most economical use of labor, material and expense.

11. It is the only means of predetermining when and to what extent financing will be necessary.

12. It acts as a target to shoot at and provides a gauge for measuring the accuracy of the shot. It is a test of the ability of management to make things happen in accordance with a well ordered plan.

13. Managements which have developed a well ordered budget plan, and which operate accordingly, find greater favor from their bankers and Boards of Directors.

14. It compels management to fortify itself with adequate accounting, cost accounting and financial records.<sup>1</sup>

**The Budget Period.**—Probably the most common periods for which business budgets are organized are 6 months and 1 year. For special purposes, the period may be shortened to a quarterly basis. For construction and long-term financing, budgets for five or more years may be formulated. It is not uncommon for the same business unit to be operated at the same time under several budgets, for different purposes, running for different periods of time. In general, the more constant the demand for the service or the products of a business, the longer it can plan ahead. It is to be

<sup>1</sup> *Ibid.*, pp. 5-6.

expected that the longer the term of the budget, the more general its provisions. Only short-term budgets are expected to be prepared in detail. The annual budget may be revised and extended quarterly or semiannually so that it always approaches a 12-month planned program.

**Organization for Budgetary Control.**—Because of the need for cooperation of department heads in framing and operating a budget, there must be a definite budgetary organization. A committee, consisting of the principal functional executives, usually formulates the budget. Periodically thereafter, the committee meets to review the operation of their program and to make such revisions as new conditions may recommend. Failure of the committee to agree upon particular items places the responsibility for decision upon the chief executive of the corporation. The treasurer is hardly in a position to render decisions in case of dispute, because the point at issue may not be directly a financial question. Even though the controller is nominal chairman of the budget committee, as sometimes occurs, matters in dispute will usually be referred to the chief executive. For this reason, it is usually advisable to have him at the head of the budget committee. His function in that position is usually that of the diplomat. In many business enterprises, budgets are submitted to boards of directors for final approval. They would scarcely be interested in or capable of formulating budgets originally.

**The Finance Budget.**—As an outgrowth of budgetary procedure, each department will receive a budgetary plan that reflects the general program for the corporation. "Lack of working capital" or "lack of capital" is frequently given as the cause of business failure. This usually means that at the time capital is most urgently needed it cannot be obtained. In other words, the need for new funds is not properly anticipated. The sales cycle, consisting of cash—supplies and services—sales—accounts receivable—cash, is expected to keep the operations going. But the cycle itself must be financed. Few businesses are able to match daily expenditures with daily receipts. Both receipts and expenditures are irregular and seldom synchronize. For this reason, cash requirements must be determined in advance, and plans must be formulated for meeting them. Such requirements cover both operating expenses and expenditures for construction and other capital acquisitions. Sources of cash to meet these two sets of conditions will vary with the purpose to be served.

In discussing the financial budget, Sinclair says:

It is the central budget which reflects a summary of the estimated cash receipts and disbursements from sources within the business, the amounts of additional funds required for financing the operations of the business as disclosed by the departmental budgets, the sources from which it is expected the funds will be received, and the periods of time for which such funds will be required.<sup>1</sup>

<sup>1</sup> Sinclair, Prior, "Budgeting" (New York, 1934), p. 57.

**Formulation.**—Preparation of the finance budget follows the formulation of plans of other departments. The usual procedure to be followed in the formulation of the former is as follows:

1. An estimate is made of expected cash receipts from all sources, including collections of old accounts and the proceeds from cash sales made within the budget period. This estimate must take into account several variables. Among them are the credit policy of the enterprise, whether sales are made for cash or on terms; the effectiveness of collection procedures; and the stage of the business cycle.

2. This is followed by an estimate of cash disbursements by all departments, including not only the financing of current operations, but the payment of notes and accounts and expenditures for capital outlays as well. An accurate estimate of cash disbursements may be more difficult than an estimate of cash receipts. At least it is likely to cover a larger number of different kinds of items. Not only labor, materials, administrative, construction, and selling expenses must be considered, but various miscellaneous items like taxes, financing expenses, etc., must be included. Depending upon the amount of cash on hand, not only will notes and accounts maturing within the budget period be included, but some maturities may be anticipated.

3. With the estimates of receipts and disbursements available, the construction of a cash budget follows. Since the conditions upon which estimates are based are subject to frequent changes, corresponding adjustments are necessary.

4. The cash budget, supplemented by the estimates of production and sales for the budget period, serve as the basis for the financial program of the corporation. The cash budget will determine whether the corporation will need supplemental financial assistance or whether it may hope to have an excess of cash over its current needs, making possible the payment of extra dividends or the purchase of outside investments. If a cash deficit is indicated, its probable nature is important. It may be seasonal only, or it may be permanent in character. The length of time for which the deficit is expected to be present will determine the source of the needed cash. In one case, a temporary bank loan would serve the purpose; in another, the sale of stocks or bonds is suggested.

**Difficulties Encountered.**—The difficulties encountered in the formulation of finance budgets relate to external conditions, to the nature of the business, or to personnel. The most important are as follows:

1. Original forecasts are difficult, and the conditions on which they are based may change.

2. Absence of complete cooperation among all departments renders finance budgets useless.

3. The timing of both receipts and disbursements may vary with changes in the business cycle.

4. The confidential nature of budgets makes exchange of ideas with other business enterprises and the establishment of standards of procedure difficult. Each corporation is dependent upon the experience of its executives.

5. Budgets constitute commitments. Many executives hesitate to make public too definite plans for fear that failure to measure up to expectations will reflect upon their ability to handle their assignments.

**Dependence upon Other Departments.**—The successful operation of the finance budget depends upon the ability of other departments of the business to make good their programs. If the production department spends more than has been allotted to it, the finance budget is confused. If the sales department fails to live up to its quota, the same result may follow. Slow collections may embarrass the finance department and cause changes in financial plans. As already indicated, allotments and quotas are guides rather than masters of the business enterprise. It may be desirable to increase the allotment to the production department, particularly if sales quotas are being exceeded. In any event, the finance budget cannot be independent of other budgets but is directly dependent upon them.

**Control of Finance Budget.**—The conditions stated in the preceding paragraph indicate the necessity for constantly checking accomplishments against expectations to determine the extent to which the finance budget should be revised from time to time. Then, too, other financial disappointments may necessitate contractions in the finance budget. Lack of success in the sale of stock and bond issues may cause postponement of construction plans. Expected bank credit may not materialize. On the other hand, improvement in business prospects beyond expectations may invite operating or capital expansions, or both, necessitating expansions in the finance budget. Effective operation of the finance budget involves control over disbursements and receipts of the various departments of the business. The treasurer, therefore, must keep in constant touch with heads of other departments, so that they may know whether or not the finances of the corporation will allow the continuation of their own plans.

**Fixed Capital.**—Budgets are sometimes thought of as means of controlling current operations only. Finance budgets attempt also to control fixed-capital expenditures. Indeed, the budget can be used as an effective means of determining the need for new construction and new equipment. About the only effective way to control capital expenditures is to review their needs carefully before they are made. In a period of prosperity, it is easy to embark upon an expansion program. Careful budget makers will demand answers to several questions which may cause future embarrassment if not met in advance. Among the more important are the following:



1. Will the additional profits justify the expenditure?
2. If additional capacity is needed, is the proposed plan the best means of supplying it?
3. Can present investment in plant and equipment be utilized to better advantage?
4. Is now the proper time to undertake the expansion program?
5. Is new financing necessary; and, if so, can it be arranged advantageously?

Corporations accustomed to seeking receipts before making commitments for disbursements will avoid mistakes made by others which undertake expansion programs without having in sight the resources with which to liquidate the obligations incurred thereby. When faced with the above questions, corporate managers may limit capital expenditures to additions, betterments, and improvements rather than undertake more expensive new construction programs. Budgetary control of fixed-capital expenditures would go far to reduce the fever of over-capacitation of plants from which industry suffers from time to time.

**Psychological Effects.**—Budgetary procedure may be of indirect benefit to the corporation that follows it. The trade-mark of budgets should be a huge question mark. The whole purpose may be stated in these words: What? Why? How? When? Any corporate official or department head who is constantly faced by these questions, when he attempts to defend his proposals and his programs, will give more careful attention to their formulation and justification than if he were permitted to conduct his department on the basis of inspiration and "hunch." From one point of view, budgetary procedure would tend to make its followers conservative; on the other hand, it induces each to give his best efforts to make the teamwork effective. The emphasis upon teamwork is evident. Undoubtedly more games are won by effective teamwork than by the spectacular performances of individual stars. In fact, the latter is made possible only by the presence of the former.

**Limitations.**—A corporation that first attempts the use of budgets may be disappointed in results because too much is expected of them. Only experience with their weaknesses, as well as their advantages, can teach the real value of their use. Budgets have distinct limitations, among which the most important are the following:

1. Budgets deal in futures. Being based upon estimates of future performance, they can be no better than the estimates upon which they are based. As the conditions resulting in the estimates change, budgets must be revised to reflect the changes.
2. Budgets are not automatic in operation. They are tools requiring skilled operatives to make them effective. They must be used sympathetically and intelligently to produce results that justify their existence.

3. They must be properly adjusted to the actual conditions facing a corporation. If they impose conditions impossible of attainment, they produce discouragement and lack of cooperation. If the standards set are too low, they fail to call forth the best efforts of those expected to use them.

4. Budgets are aids to administration, not substitutes for business judgment. They are not intended to deprive business executives of responsibility for results or of freedom of action in attaining them. However, executives, as well as others, should have sufficient reasons before abandoning the use of a budget once it is set up.

5. It takes time to accustom people to the use of new methods of procedure. Budgets must not be expected to result in immediate acceptance by those unacquainted with their use. The accuracy of such budgets will be open to question. Experience should help to make budgetary procedure cumulatively more effective.

**Budget Manuals.**—An aid to both the introduction and the proper operation of budgetary procedure is the budget manual, used by many companies. It is intended for internal use to acquaint all concerned with the purpose, procedure, and administration of the company's budget. When such subjects are set down in written form, all may understand what is intended. Such manuals may be general in nature, dealing only with the broad outlines of the subject. Others may go into considerable detail for the purpose of anticipating most of the questions that may be raised about their content. Some are in narrative form, some in outline, and still others in the form of questions and answers. Those who are responsible for the preparation of such manuals follow the principle that what is worth doing is worth describing in a manner that is readily understood by those to be affected.

### QUESTIONS AND SUGGESTIONS

1. Differentiate between internal and external corporate relationships.
2. What is an unmanaged business? Give examples from your own observation.
3. What is the meaning of financial control?
4. Define business forecasting. With what is it concerned? Why is accurate forecasting difficult?
5. Name several common forecasting services available to business executives.
6. What indices are used in business forecasting? Which of these do you consider most important? Why?
7. What constitutes the financial department of a corporation?
8. List the duties of the treasurer. What kinds of liabilities is he subject to?
9. What are the functions of the finance committee?
10. What are the functions of the controller? Do all corporations have a controller?
11. What is a business budget? Who is responsible for its preparation?
12. What is the relationship between budgeting and forecasting?
13. What is meant by the statement that budgeting is a coordinating process?

14. What periods are covered by budgets? May a corporation use different periods at the same time? Explain.
15. What is the finance budget, and what is its primary function?
16. What difficulties are encountered in budget making?
17. What are the limitations of budgets?
18. What is a budget manual? What should it cover?

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#### SUBJECTS FOR INVESTIGATION

1. From your review of forecasting services available to business executives, what is your estimate of their reliability? Why?
2. Interview any businessman of your acquaintance, and determine his experience with budgets. If it is negative or unfavorable, find out why.
3. Find out if the finance budget is taken as seriously as the production budget, and account for any differences that you find.

## CHAPTER XXVII

### CORPORATE REPORTS

**Kinds of Corporate Reports.**—Corporations normally have prepared a variety of reports, each of which is intended to serve one or more purposes. Some are for internal control only and may not even be distributed to the directors. Others are for general management uses, including distribution to directors. Some are handed out at directors' meetings; occasionally such reports are mailed to directors in anticipation of meetings. There may be reason to have frequent, almost daily, reports of certain kinds distributed to directors and officers. Tax collectors and regulatory authorities are accustomed to require corporate reports, prepared on forms prescribed by the agency that receives them. For the most part, the above kinds of reports are not intended for public use, although those filed with tax and regulatory authorities may be subject to public inspection. Finally, there are statements prepared for stockholders and others interested in the affairs of the corporation. These form the subject matter of this chapter.

While it is not to be expected that all the types of reports mentioned in the preceding paragraph shall follow the same pattern, the information presented in one type of report should seldom be in conflict with that presented in another type. Frequently, excuses are made for including in stockholders' reports much less factual information than is presented to officers and directors, on the ground that competitors may receive an undue advantage from what they can read in a report that is widely circulated. Such arguments may have some weight. It is probable, however, that they are less valid than is customarily assumed. Probably custom, rather than logic based upon detailed analysis, dictates the form and content of most published reports. Also, as pointed out elsewhere in this text, other reasons than strict adherence to stockholders' interests determine the amount and kinds of information given them.

**Reports to Stockholders.**—As already indicated, stockholders play no part in the formulation of the financial policies of the corporation except to provide it with the capital needed to get it started and perhaps to assist in making available additional sums needed for expansion of operations. Both custom and law recognize the rights of stockholders to be kept informed about the progress of the corporations that they finance. Corporate managements usually make at least annual reports to their stockholders. Some

laws require annual reports. The Corporation Code of Ohio contains the following provision:

At the annual meeting, or at any other meeting at which directors are to be elected, every corporation, except banks, shall lay before the shareholders a statement of profit and loss and a balance sheet containing a summary of the assets and liabilities, a summary of profits earned, dividends paid, and other changes in the surplus account of the company, made up to a date not more than four months before such meeting, from the date up to which the last preceding statement, account, and balance sheet were made up, and in the case of the first statement and balance sheet, from the incorporation of the company.<sup>1</sup>

The Ohio law is more progressive than that of some other states in protecting the right of the stockholder to information about the affairs of his corporation. Yet "inside" stockholders, members of the official family of the corporation, would hardly care to base their own investment judgment upon the information required by the Ohio law.

**Stock Exchange Recommendations.**—The New York Stock Exchange has recognized the need for improvement in reports to stockholders. A letter sent from its listing committee to corporate executives includes the following recommendations:

1. When the books and accounts are audited by public accountants, the text of the auditor's certificate should be included in the report.

2. The number of shares of capital stock authorized and the number outstanding should be shown on the balance sheet.

3. The number of shares and the amount of holdings of the corporation's own unretired stock and bonds should be separately disclosed, with indication of valuation and the basis on which they are carried.

4. Surplus should be designated as capital surplus and earned surplus.

5. Changes in either capital or earned surplus should be indicated by adjustments.

6. Differences between the cost and the subsequent retirement or resale price should be fully disclosed.

7. There should be a full disclosure of any change in the bases of valuation of investments, inventories, or property accounts.

8. Any change in depreciation policies should be fully defined.

9. The principal component parts of "other income" should be disclosed.

10. A complete list of directors and officers should be included in the report.

**Functions.**—Annual reports to stockholders should have as their prime functions facilitation of analysis of the affairs of the corporation and provision of aid to judgment concerning the investment quality of its securities. The usefulness of the report, therefore, depends upon the

<sup>1</sup>General Corporation Act of Ohio, Sec. 8,623-8,664.

desirable to break down the above minimums into major divisions at least. Many corporations report income statements in much greater detail. Under the urge of public pressure, the tendency is to make income statements and balance sheets more useful than formerly.

**Uses of Reports.**—The writer has no delusions about the uses to which reports to stockholders are put. Aside from their reproduction and quotation by investment services, manuals, and financial publications, an occasional interested party reads them and tries to interpret them. Few stockholders read them and would understand them if they did. Undoubtedly, part of this lack of use is due to the form and contents of the reports. A good illustration of the lack of interest displayed in corporate reports was quoted by the *Wall Street Journal* of July 27, 1942. A corporation with over 25,000 stockholders offered to mail its quarterly report to stockholders and others interested in it. The total number of names on its mailing list, including newspapers, investment houses, etc., was only 350. Incidentally, the earnings and the prices of this corporation's securities fluctuated quite widely. Still the stockholders were apparently not interested to learn why.

Corporate managements need use only the accounting and statistical knowledge at their command in order to prepare reports that will be more readable, more widely read, and more useful.

**Difficulties Encountered in Reading Statements.**—An editorial in the *Accounting Review* for September, 1932, undertakes to explain why financial statements are hard to read. The writer presents these reasons:

1. The investor is usually unfamiliar with the forms, customs, and terms of the financial world.

2. They are not presented in conventional form to facilitate comparisons.

3. The statements themselves have been prepared either unintelligently or with the express idea of concealing rather than revealing information. . . . The reason so often given, namely that competitors may seize upon and make use of this information, can be justified only in rare instances.

Because of the inadequacy and ambiguity of financial statements, it is frequently necessary to recast their contents into simplified form before they can be of much use for analytical purposes.

**Interpretation Needed.**—Accounting statements are never statements of cold facts. They are always statements of opinion. In their very nature, they must reflect someone's estimate of values. Unfortunately, at times the opinion that the accountant is directed to record is not always accurate. It may be based upon lack of information, upon misinformation, or even upon "selected" information. Because of the necessary dependence of accounting statements upon opinions, the compilers thereof should assist the reader by furnishing with the statements—either in footnotes or in supplementary statements—all information necessary to a proper interpretation of items included in the statements. Regard should always be had for the

purposes the statement is intended to serve and the audience it will probably reach.

**Use of Ratios.**—Elaborate systems of ratio analysis have been built up from time to time. Faith in ratios is so strong with some people that it becomes their theology. At best, ratios are aids to business judgment—not substitutes therefor. Business judgment involves discovering and weighing business relationships. These relationships are frequently expressed in the form of ratios. Profitable business results from favorable relationships, such as the following:

1. Efficient production operations.
2. Good merchandising.
3. Satisfactory inventory turnover.
4. Prompt collection of accounts.
5. Adequate working capital.
6. Sufficient plant investment.

All the qualifying terms used here—efficient, good, satisfactory, prompt, adequate, sufficient—are relatives, measured by comparison with similar conditions. These relatives change from time to time and produce results that differ when their combinations change. In a period of depression, satisfaction might be felt and expressed when losses decrease, not when gains increase. In periods of great prosperity, everyone looks for maximum gains and is not satisfied with less.

In using ratios of any kind, their limitations must be kept in mind. Since a ratio results from establishing the relationship between two numerically expressed amounts, the ratio can be no more accurate than are the amounts from which it is derived. Any single ratio, therefore, may be open to question. The problem is further complicated in comparing ratios to make sure that they are computed alike. Particularly, in comparing the ratios applicable to one corporation with those of another, care should be exercised to determine to what extent like bases are being used. Otherwise, what appears to be a correlation may be quite misleading.

**Kinds of Ratios.**—A considerable number of kinds of ratios are in common use. For example, in the railroad industry much attention is given to the operating ratio or the relationship of operating expenses to revenue, to the average trainload, to the average car miles per day, to the fuel consumption per locomotive mile, etc. In attempting to measure the investment status of bonds, attention is given to the ratio of stocks to bonds. In qualifying bonds as acceptable investments for savings banks, New York provides that the capital stock shall be at least two-thirds as large as the bonded debt. Current-asset ratios are used to determine that the corporation has ample cash for current needs, that it is able to meet its current liabilities as they fall due, and that the relationship between the current assets and the funded debt is consistent with the character of the industry.

Here is an excellent illustration of the futility of trying to establish arbitrary ratios for test purposes, except for the specific purpose that the test should serve. For example, in a hydroelectric plant or a railroad, the ratio of current assets to funded debt is very low; in a merchandising or manufacturing business, it is usually much higher.

Koch found that for 1937 the ratio of current assets and current liabilities to total assets for the indicated groups were as follows:<sup>1</sup>

Group	Percentage of current assets to total assets	Percentage of current liabilities to total assets
Trade.....	63	34
Manufacturing.....	39	17
Electric light and power.....	6	4
Telephone... ..	6	4
Railroads.....	4	7

The same author found that the ratios of the sum of cash, receivables, and inventory to total assets for the same year varied from 27 per cent for small corporations to 18 per cent for medium-sized and to only 10 per cent for large corporations.<sup>2</sup>

Perhaps more important in many instances than the relationship between current assets and current liabilities in measuring the current position of the corporation is the comparison of cash, marketable securities, and receivables with current liabilities. This comparison assumes that marketable securities are actually marketable if necessary and that the receivables are owed by solvent concerns. Still another test of the current position of a business is the ratio of current liabilities to tangible net worth. As a measure of liquidation possibilities, it has more weight than as a measure of the strength of a going concern. Nevertheless, it helps to determine credit standing, even for the latter. Creditors are inclined to agree with the slogan of the Rothschilds which reads, "Do not trust a man who owes too much." For business enterprises that have outstanding long-term debt, the ratio of total liabilities to tangible net worth becomes significant. While deferred liabilities are not so pressing as those that are current, they help to determine the credit standing of the debtor. Not only their amount but their nature must be analyzed. Early maturities weigh heavier than those postponed to a future date.

<sup>1</sup> Koch, A. R., "The Financing of Large Corporations" (New York, 1943), pp. 42 and 61.

<sup>2</sup> *Ibid.*, p. 18.



The ratio of funded debt to net working capital assumes great importance in some industries, particularly at inconvenient periods of the business cycle. The obligations of interest and amortization provision of bond issues prove burdensome when earnings are low. Equally important is the ratio of fixed assets to tangible net worth. Here again, industrial classification plays a heavy role. For example, a steam railroad would show a very high ratio, most manufacturing concerns somewhat lower, retail establishments still lower, and financial institutions much lower.

**Times Earned Ratios.**—For the purpose of comparing one corporation with another and with an established norm for the industry, several ratios that are expressed as “times earned” are significant. Where there are interest-bearing obligations outstanding, the number of times fixed charges are earned is very important. This ratio, like the others to follow in this paragraph, should be computed for the current period, to be expressed as a maximum and a minimum for the preceding seven to ten years, and as a trend showing which way the earnings are moving in relation to fixed charges. Next, the earnings on preferred stock should be shown in a similar manner. Then follows a similar set of figures for common stock. Dividends paid on preferred and common stock usually follow, using the same pattern outlined above. Other ratios, such as earnings on each class of stock to its market price, are significant. As a means of assisting present and prospective security owners and creditors better to understand the financial position of a corporation, there appears to be no good reason why such ratios should not be included in the annual reports to stockholders.

**Operating Ratios.**—In addition to the standard operating ratio—operating expenses to gross—mentioned above, there are several other types of ratios that have varying degrees of importance in different kinds of industries. For example, the ratio of net sales to tangible net worth indicates the rate of turnover of owned capital. If the ratio is too high, in comparison with the norm for the industry, it may indicate the excessive use of credit. While this may suggest a certain type of shrewdness on the part of management, it also may suggest a high degree of vulnerability to changing conditions due to business recessions. Either additional capital investment or a more prompt collection policy may be applied as a remedy. If, on the other hand, the foregoing ratio is abnormally low, either an increase of sales or a decrease in investment may be the answer. The latter is not always easily accomplished and may not produce desired results if it is tried. It may be that sufficient volume of sales cannot be developed to support profitable operations on any investment.

Where the ratio of net sales to net working capital is unusually high, this may indicate a lack of balance between the investment in fixed capital and circulating capital and suggest the need for increasing the latter. On the other hand, if the high ratio is only temporary, perhaps a proper balance will

soon be restored. An unusually low ratio may indicate that the particular business enterprise cannot use to advantage its total invested capital.

**Relative Importance of Ratios.**—It is not to be assumed that, in using these ratios, the same weight shall be given to each. Probably the current ratio, showing the margin of current assets over current liabilities, and the ratio of net worth to debt, indicating the soundness of the capital structure, are entitled to more weight than are most other ratios. One writer proposes the following table of weights to be given to ratios:<sup>1</sup>

RATIO WEIGHT TABLE

	Per cent
Current ratio .....	25
Net worth to fixed assets .....	15
Net worth to debt.....	25
Sales to receivables.....	10
Sales to inventory.....	10
Sales to fixed assets.....	10
Sales to net worth.....	5
Total .....	<u>100</u>

A few recent examples show how comparison is being facilitated. The first subject dealt with in the 1945 annual report of the Standard Oil Co. (New Jersey) is entitled "Financial and Operating Summary." Here in parallel columns, statistics for 1945, 1944, and 5-year average are published opposite the following captions:

	1945	1944	5-year Average
<b>Income and Surplus</b>			
Total income .....	\$1,635,886,000	\$1,652,806,000	\$1,336,965,000
Total costs and other deductions.....	\$1,481,730,000	\$1,497,410,000	\$1,206,002,000
Net profit .....	\$154,156,000	\$155,396,000	\$130,963,000
Net profit per share.....	\$5.64	\$5.69	\$4.80
Percentage of net profit to total income	9.42	9.40	9.80
Dividends paid .....	\$68,334,000	\$68,271,000	\$62,784,000
Dividends paid per share.....	\$2.50	\$2.50	\$2.30
Interest on long-term indebtedness.....	\$6,008,000	\$6,643,000	\$6,056,000
<b>Balance sheet—December 31</b>			
Property, plant and equipment, less reserves .....	\$1,137,441,000	\$1,103,126,000	\$1,095,536,000
Current assets .....	\$1,043,898,000	\$1,027,711,000	\$862,116,000
Current liabilities .....	\$264,079,000	\$330,633,000	\$249,174,000
Net working capital .....	\$779,819,000	\$697,078,000	\$612,942,000
Ratio of current assets to current liabilities	3.95	3.11	3.46
Funded and other long-term indebtedness	\$203,130,000	\$214,855,000	\$218,545,000
Net worth (capital stock and surplus)...	\$1,539,631,000	\$1,444,651,000	\$1,396,267,000
Net worth per share .....	\$56.33	\$52.85	\$51.14

<sup>1</sup> Wall, A., "Basic Financial Statement Analysis" (New York: Harper & Brothers, 1942), p. 65.

Operating statistics	1945	1944	5-year Average
Wages, salaries and employee benefits...	\$314,042,000	\$275,840,000	\$246,954,000
Taxes charged to income.....	\$109,017,000	\$158,780,000	\$114,277,000
Taxes collected for states and others....	\$161,448,000	\$144,255,000	\$142,889,000
Gross crude-oil production (barrels daily):			
United States .....	423,000	430,000	342,000
Other Western Hemisphere .....	514,000	493,000	425,000
Totals .....	937,000	923,000	767,000
Crude-oil refinery runs (barrels only):			
United States .....	606,000	585,000	500,000
Other Western Hemisphere .....	514,000	483,000	430,000
Totals .....	937,000	923,000	767,000
Number of shares outstanding (year end)	27,333,742	27,333,742	27,303,649
Number of shareholders (year end).....	160,000	155,000	151,000
Number of employees (year end).....	108,000	97,000	94,000

The annual report of the U.S. Steel Corp. for the year 1944 gives, in parallel columns for each year from 1902 to 1944, the following information: in thousands of net tons—ores mined, fluxes produced, coal mined, coke produced, iron produced, ingots and castings produced (with percentage of capacity operated), and finished steel shipped; in millions of dollars—products and services sold, employment costs, taxes accrued, products and services bought, wear and exhaustion, interest paid on debt, income or loss, preferred-stock dividend, common-stock dividend, “for future needs,” and total investment; also average number of employees and percentage earned on investment.

These examples indicate steps in the right direction. We still have a long way to go in progressing toward the goal of educating security holders.

**Trends.**—The emphasis upon relationships and changes in relationships points to the need for comparative statements for intelligent analysis. A single balance sheet or income statement might lead to conclusions entirely denied by a historical picture. It is important to know where a corporation is at a particular time: it is also important to know where it came from and where it seems to be going. Averages are frequently misleading. Two corporations may have had the following earnings' history:

Year	Net profits	
	Corporation A	Corporation B
1942	\$10,000	Loss
1943	9,000	\$1,000
1944	8,000	2,000
1945	7,000	3,000
1946	6,000	4,000
1947	5,000	5,000

The average annual earnings for the 6-year period is favorable to corporation A. But what a difference in trend! Should the earnings statements for the year 1947 only be studied, the two corporations show the same net earnings. The investor might be misled into putting the stocks of the two corporations in the same class unless he has before him a study in trends.

**Comparison.**—In fact, all analysis implies comparison. Stockholders and others who use corporate reports are constantly weighing and comparing various similar investment opportunities. Much of the activity in security markets results from shifts from one stock or bond to another whenever an advantage is presented or appears to be present. Ratios are useful instruments for measuring relative advantages among investment opportunities—provided that too much dependence is not placed upon them. Again they should be used as aids to judgment, not substitutes therefor.

**Reform in Reports.**—The bad repute enjoyed by the term “reform” causes the present writer to hesitate before using it. Yet the situation seems to be served adequately by no other word. Corporate reports to stockholders should be reformed. Every intelligent analyst restates much of the information contained in current reports before he puts much faith in it. Much of the “alteration” necessary to inject accuracy and dependability into some reports is comparable to having a tailor “alter” a pair of red trousers into a blue coat. The rights of stockholders, bondholders, and creditors to accurate and complete information should be recognized. Steps should then be taken to make such information available. For years, investment bankers have urged greater accuracy, completeness, and frequency in corporate reports. Accountants stand ready to supply the need. The decision for a change in policy rests with corporate managers.

**Recent Interest in Changes.**—Within recent years, numerous publications interested in business operations have given attention, editorially and otherwise, to the need for changes in corporate reports to stockholders. Among these are *Printers' Ink*, *Sales Management*, and *Trusts and Estates*. Some of these publications suggest that the public-relations manager and the advertising manager should participate in the preparation of reports. Other suggestions recommend the inclusion in corporate reports of such subjects as other business affiliations of officers and directors, future plans of the corporation, taxes, employee and consumer relations programs, advertising plans, research programs under way, description of products, etc. The new value of these reports is emphasized and the further suggestions are made that copies be sent not only to newspapers but to clients, suppliers, trade associations, officials of state and Federal governments, and educational institutions.

**Changing Attitude of Accountants.**—It is heartening to note the general awakening of accountants to their responsibilities to corporate investors. Several years ago, a leading article in the *Journal of Accountancy*, entitled “Accounting for Investors,” pointed out that accounting had been placing

emphasis upon (1) giving to management accurate information essential to the successful conduct of the business; and (2) giving to actual and prospective creditors accurate information essential to the determination of proper policies of extending credit to the corporation in question. The article points the need for giving to the investor such information as will enable him to determine the true value of his investments.<sup>1</sup>

In the *Accounting Review* for March, 1936, appears a "Statement of Objectives of the American Accounting Association," later reprinted in pamphlet form. In this statement appears the following:

Accounting, originally designed for the purpose of providing internal control of business affairs by private owners, now finds itself faced with the responsibility of compiling and expressing the results of business operations in a way which will meet the needs of investors, governmental units, and the public at large, as well as those of the immediate management.

In a "tentative statement of accounting principles underlying corporate financial statements," by the executive committee of the American Accounting Association, appears the following: "Every corporate report should be based on accounting principles which are sufficiently uniform and well understood to justify the forming of opinions as to the condition and progress of the business enterprise behind it." Corporate directors, officers, and employees responsible for the preparation of corporate reports will find much food for thought in the sound advice contained in this "tentative statement."<sup>2</sup>

**Participation by Department of Commerce.**—In 1934, the committee on statistical reporting and uniform accounting for industry reported to the business and advisory and planning council of the U. S. Department of Commerce the need for improvements in accounting reports to stockholders. The committee, headed by Walter S. Gifford, had as the other members Pierre S. du Pont and William A. Harriman. The report was developed by Prof. T. H. Saunders. Topics dealt with included consistent application of principles, uniform accounting and reporting practices, frequency and date of publication, consolidated statements, comparative statements, and need for conservatism.

<sup>1</sup> Hoxsey, J. M. B., *Accounting for Investors*, *Journal of Accountancy*, October, 1930, pp. 251-284.

See also the following articles:

Andrews, F. B., *The Public Accountant and the Investing Public*, *Journal of Accountancy*, January, 1934, pp. 55-65.

Morrison, P. L., *Reports to Stockholders*, *Accounting Review*, March, 1935, pp. 77-83.

Paton, W. A., *Shortcomings of Present-day Financial Statements*, *Journal of Accountancy*, February, 1934, pp. 108-132.

Voss, Wilhelm, *Corporate Auditing Requirements under German Commercial Law*, *Accounting Review*, December, 1930, pp. 305-307.

<sup>2</sup> Reprinted from the *Accounting Review*, June, 1936, p. 4.

**English Experience.**—The well-known English practice of requiring by law that every public corporation shall be audited by an independent auditor chosen by and responsible to the investors raises the interesting question, "Why can't that happen here?" The ready-at-hand answer "Because of the ineptitude of legislators in the multiplicity of states which bid for the favor of managements instead of investors" states a fact but does not satisfy the impartial student of finance. It is probably true that the adoption, by only a few states, of compulsory audits by independent auditors selected by and responsible to investors would drive some corporations to other states. Nevertheless, the need for such audits is so obvious that, in the interest of the corporations themselves, some means must be found to bring them into common use.

**Limitations upon English Practice.**—Since there is no statutory definition of the extent of the audit, the liability of the auditor is left to court determination. In discussing this subject, an English observer says:

In cases which have come before the Courts where the Auditor's functions and duties were under consideration, the Judges have expressed the view that Auditors are watchdogs and not bloodhounds; that in proper circumstances they are not to be held responsible for tracking down deeply laid schemes whereunder accounts have been falsified; that they are entitled to place reliance on the explanations given them and the views expressed by trusted officials of the Company, and, in the absence of suspicious circumstances, to accept as correct the information so given them; that they are entitled to rely on the efficiency of properly devised systems of internal control which may be in operation; and that in proper cases their duty is covered by testing at random the correctness of certain classes of book entries and assuming that the similar entries not checked by them are correct.<sup>1</sup>

**American and German Experience.**—In prewar Germany, every corporation was required to furnish its stockholders with a balance sheet and an income statement, the forms of which were prescribed in considerable detail. Such statements were accompanied by an auditor's report which certified that the statements were in agreement with the corporate records and that the statutory requirements relative to capital accounts had been observed.<sup>2</sup> Without any statutory requirements compelling independent audits of American corporations, a considerable number provide their stockholders with this kind of protection. As early as 1933, one student of the question reported that 87 per cent of America's 83 largest corporations and that 83 per cent of the corporations whose stock was listed on the New York Stock Exchange employed independent auditors.<sup>3</sup> It is to be expected that, over

<sup>1</sup> Cutforth, A. E., "Public Companies and the Investor (London, 1930), pp. 143-144.

<sup>2</sup> Andrews, F. B., Compulsory Audit of Corporations, *Journal of Accountancy*, November, 1932, pp. 351-369.

<sup>3</sup> Barton, Roger, Independent Audit for Investors, *Journal of Accountancy*, August, 1933, pp. 91-101.

a period of years, even the wording of the certificate of independent auditors should approach standardization. For example, the following practically identical phraseology is in current use by different well-known accounting firms in certifying audits of the books of different corporations:

Our examination was made in accordance with generally accepted auditing standards applicable in the circumstances. . . . In our opinion the accompanying . . . statements fairly present . . . the results of their operations for the year, in conformity with generally accepted accounting principles applied on a basis consistent (in all material respects) with that of the preceding year.

Within recent years, under the encouragement of the rules and regulations of the Securities and Exchange Commission, requests sent to stockholders for proxies to be used at annual meetings have frequently contained resolutions calling for the appointment of independent auditors. Such resolutions were usually initiated by small groups of stockholders not directly members of the management family. Exercising their rights under the commission's rules by commenting on such resolutions, some managements have given the requests for the appointment of independent auditors their wholehearted support and have urged stockholders to vote affirmatively for the requests. In at least one case the head of a corporation whose salary had amounted to hundreds of thousands of dollars annually had even threatened to resign if the stockholders approved the appointment of independent auditors. Just as a matter of curiosity, it would be interesting to see how many fat salaries would actually be sacrificed on an issue of this kind.

**Securities and Exchange Commission.**—By piecing together various bits of the authority granted by Congress to the Securities and Exchange Commission, it has very broad powers over the kind of reports that American corporations with listed securities may make to those interested in its affairs. Such powers include not only the authority to require independent audits; the commission may even prescribe accounting methods in the keeping of records upon which reports are based. To date, very little of this power has been used. It is probably well to proceed slowly because of the lack of standardization of records and of accounting procedures. It is to be hoped, however, that sooner or later the commission will exercise leadership and authority if necessary to render a signal service to all who are interested in the interpretation of the financial statements of corporations. By recognizing the need for reasonable exceptions and modifications in record keeping and reporting techniques, the commission can help to raise the standards of the whole corporate-accounting profession. By standardization of accounting practices and by insistence upon independent audits, reports to stockholders and others may become much more useful than they have ever been heretofore. The accuracy, the frequency, and the completeness of such reports

are in the hands of the commission. Raising of the standards of reports of corporations with listed securities will undoubtedly influence the practices of those corporations whose securities are not listed.

**Illustrated Reports.**—Within recent years, some experiments have been made in the use of illustrations in corporate reports. The annual report of the Standard Oil Co. (New Jersey) for the year 1945 featured a number of maps showing the location throughout the world of its operations. In addition it contained several charts which visualized in brief space the progress made by this corporation over a period of years. Incidentally, this report contains an interesting section entitled "Review of the Year" which deals with such subjects as new officers and directors, production, refining, transportation, marketing, research and development, employee relations, working capital, properties, funded and long-term debt, and patents, copyrights, and good will. All who read this report will know more about this company than otherwise. In a special 62-page edition of the company's employee magazine, under date of Jan. 10, 1945, the company published many rare and unusual photographs showing the history of the company and the uses of its products over the preceding seventy-five years. This too was distributed to its shareholders.

The annual report of the General Motors Corp. for the year 1945 was profusely illustrated with pictures of various processes in the manufacture of automobiles. This report also made use of charts and graphs in a manner to tell its story briefly but convincingly. It is evident in the study of some reports to stockholders that their organizers have been sold on the idea of illustrated reports without knowing just how to put the idea to use. The illustrations in some recent reports will undoubtedly cause confusion in the minds of the nonprofessional readers but will probably carry no specific message that will justify the expense of the illustrations.

**Giving the Facts.**—In its annual report for 1945, the General Motors Corp. starts with a statement of "Policy of Giving the Facts" which includes the following:

It has long been the practice of the management in its annual reports and other messages to stockholders to provide information which will contribute to the fullest possible understanding of General Motors' position and its operating policies. The annual report supplements the quarterly reports and other messages and summarizes the pertinent information for the year from a statistical, financial and policy standpoint. When issued to stockholders these reports become matters of public record. The major operating results are released for publication, and copies of the reports are available to the public upon request.

The report then proceeds for half a hundred pages to discuss its policies under the following topical headings: high lights of the report; an operating review; looking to the future; relationships with the employees; a lesson of the war; research—engineering—styling; relationships with the public;



ownership of General Motors; war production, volume, and profit policy; a financial review; and conclusion. Then follows the usual financial statements, including income, surplus, and balance sheet analysis. A page of "notes to financial statements" is very useful to the analyst. The statistical tables include a 29-year analysis of sales, net income, dividend, and reinvestment programs; a 10-year analysis of pay rolls and number of employees; and an analysis of unit sales of cars and trucks for a similar period of time. The details of the company's bonus plan with an analysis of bonus awards for each of the past nine years closes the report, except for a catalogue of the General Motors Units and the products produced by them.

By way of contrast, the report of a well-known railroad company for 1945 contains a two-line acknowledgement of the loyalty of employees and officers during the year, followed by pages of financial and operating statistics, couched in the pattern long used by railroad reports. The expert analyst of railroad reports will find on these pages the kind of statistical information he is accustomed to. Others may give the map of the states through which the road operates a passing glance.

### QUESTIONS AND SUGGESTIONS

1. With what kinds of reports are corporations concerned?
2. Why are reports to stockholders less detailed than those intended for the use of directors and officers?
3. What part does the law play in governing reports to stockholders? What is the attitude of the New York Stock Exchange on the subject of stockholders' reports?
4. What are the functions of reports to stockholders? What is meant by the propaganda nature of such reports?
5. Are the contents of stockholder reports standardized? Explain. What uses are made of such reports?
6. What difficulties are encountered in reading them?
7. What is the significance of ratios in corporate reports?
8. What cautions should be observed in the use of ratios? What kinds of ratios are most useful?
9. What ratios are used to describe the current position of the business?
10. What are times earned ratios, and how are they used?
11. Should all ratios be given equal weight? Explain.
12. Evaluate the financial and operating summary section of the 1945 annual report of the Standard Oil Co. (New Jersey).
13. How important are trends in appraising corporate results? Give examples.
14. What kinds of business publications are becoming interested in corporate reports?
15. What part do accountants play in the preparation of corporate reports? Who else should have a part in this work?
16. What is the English experience with corporate reports? What are its limitations?
17. What was the prewar German experience?
18. What is the attitude of corporate officials toward independent audits? What is your attitude and why?
19. What are the possibilities and the limitations of illustrated reports?
20. What inferences do you draw from the summary of the report of the General Motors Corp.?

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## SUBJECTS FOR INVESTIGATION

1. Obtain a corporate report to stockholders that you consider to be reasonably satisfactory, and tell why you think well of it.
2. Obtain one that you think is unsatisfactory, and give your reasons for so classifying it.
3. Read the certificate of an independent auditor, and then rewrite it in your own words. Tell what you think the weaknesses of the scope of the audit are.

## CHAPTER XXVIII

### SHORT-TERM FINANCING

**Sources of Current Assets.**—Because of the fluidity of current assets, it is possible to obtain them from a variety of sources. As was pointed out in a preceding chapter, a part of the investment in current assets is as permanent as the investment in fixed assets. That part should be financed permanently. Here the corporation has available several possibilities. In the establishment of a new business enterprise, it is well to sell enough securities to provide not only the fixed capital needed, but the minimum amount of current assets as well. As the business grows, it is to be expected that the additional amounts needed for this purpose will frequently come from undistributed earnings. It is also possible for corporations to take advantage of favorable money markets to use the proceeds from the sale of new stock issues to get rid of other kinds of obligations previously incurred in the acquisition of current assets. A corporation that is able to finance a part of its current assets from the sale of stock is better protected against financial storms than one that depends too largely upon other sources.

In American experience, few corporations pay out all their earnings in the form of dividends. The amounts retained in the business are usually available for current operations. If they should be used to finance fixed capital, it is not uncommon to reimburse the treasury by the sale of stocks or bonds to provide the long-term financing needed for fixed capital purposes. If the earnings retained are sufficiently large to take care of both fixed and current capital, such reimbursement may not be needed. Occasionally, a corporation will pass or reduce a dividend when the demands for cash to provide current assets are sufficiently pressing.

Even bonds are sometimes used to finance current assets. They should be used sparingly for this purpose. Whenever it is possible to use stock, bonds should not be called upon to provide current assets. In case the corporation has no other available source of funds for this purpose and is forced to issue bonds, the amount should be limited to the minimum requirements. It is not good policy to assume fixed charges for a purpose that may only be temporary, leaving the current assets idle for much of the time. Even when bonds are used to finance permanent investment in current assets, it is well to take advantage of subsequent favorable money markets to refinance them into the form of stock.

**Financing Temporary Investments.**—Most corporations experience considerable fluctuations in their need for current assets. The same is true to

a smaller degree of fixed assets. It is seldom possible to add fixed assets for a short period of time. But it is desirable to add current assets as needed and to dispose of them in the orderly course of business operations. In addition to the minimum investment in current assets, discussed above, each corporation faces the problem of providing the funds needed to acquire the current assets required to meet peak loads of one kind and another. Here a variety of sources are available. Some are utilized quite regularly, while others are called upon only in emergencies. In the first place, the sources discussed for permanent investment are also available for temporary investment in current assets. Stocks, bonds, and accumulated earnings may be used even for temporary needs. Since they cannot be contracted readily, their use would probably result in idle capital when the current assets are no longer needed. Fixed assets may be idle also. But little can be done about that. Since something can be done to avoid the consequences of idle current capital, other sources of temporary investment therein are commonly used.

**Bank Credit.**—Among the major purposes for which our commercial bank structure was organized was the financing of temporary needs of business enterprises. As the depository of the surplus funds of many people, the bank was expected to aid materially in the financing of the production and the distribution of goods and services. For many corporations, the commercial bank is still a source of temporary investment in current assets. But it has lost its position of leadership in this field. For more than two decades, commercial banks have been suffering from decreases in the demand for commercial loans. Several reasons combine to account for this loss. One important factor is the changing nature of inventory policies. Immediately following the First World War, many corporations were severely pinched by large bank loans contracted to carry large inventories at high prices. With the precipitate drop in prices in the early 1920's, losses were very great. Some of these corporations learned a lesson that they have not yet forgotten. They have carried smaller inventories, and they have depended less upon bank loans to finance them.

Meantime, the banks have been subjected to more strict regulation, partly as the result of the flood of bank failures that followed the stock-market crash of 1929. As a consequence, there has been a greater emphasis upon the certainty of the liquidity of bank loans. This also goes back to the years immediately following the First World War. While the corporations with heavy bank loans were severely punished at that time, the banks were not entirely comfortable in their own positions. Since they dared not insist upon immediate payment of all commercial loans at their maturity dates, they were forced to carry many loans longer than they had intended. Since that date both the banks and the governmental agencies that regulate them have insisted upon greater assurances of liquidity. This has restricted their

opportunities to make loans for meeting the temporary financial needs of business enterprises.

**Line of Credit.**—In seeking bank loans for the purpose of financing investment in current assets, a corporation is expected to establish more or less permanent banking connections. The bank is supposed to know the business enterprise and its management well enough to be able to fix a line of credit that it can safely extend to the corporation. This line of credit represents the maximum that the bank will lend to the corporation under the circumstances prevailing at the time the line is fixed. Changing circumstances presumably would call for corresponding changes in the line of credit. In fixing the line of credit for a specific corporation, several factors are considered. The bank is expected to study and to understand the financial position of the corporation, together with its future prospects. Personal relationships between the bank and the corporation management play their part also.

Then there are several mathematical formulas that are commonly employed. One is the traditional two-for-one ratio. It is understood that the purpose of the loan is to enable the corporation to buy raw materials and that the loan will be repaid from the proceeds of the sale of the finished product made from these raw materials. Nevertheless, the bank always thinks in terms of its ability to collect the loan, even though the plans of the corporation are not carried out according to schedule. Consequently, it has been customary to insist that the corporation shall invest in its current assets as much as it borrows from the bank. This makes the ratio of current assets to current liabilities two for one. If it becomes necessary for the bank to insist upon the forced liquidation of the current assets to meet the current liabilities of the corporation, it is expected that there will be a shrinkage in value. It is hoped by the bank that the shrinkage will not be more than 50 per cent and that a two-for-one ratio will amply protect the bank loan. This ratio is still taken into account in making some bank loans even where the proceeds are not used to finance the purchase of raw materials. It is evident, however, that this two-for-one ratio is not currently given the consideration that it once received. Experiences like those which accompanied the drastic drop in prices following the First World War have demonstrated that no arbitrary ratio can assure the immediate collection of a loan by a bank. Also more emphasis is now being placed upon earning power than upon asset valuations.

Another mathematical formula that has played its part in banking practices is the 20 per cent rule. This means that the borrowing corporation is expected to maintain a bank balance that will never be less than 20 per cent of the amount of the loan. In effect this causes the corporation to borrow 25 per cent more than it needs. If it needs \$100,000 it must borrow \$125,000 in order to keep 20 per cent of its loan on deposit at all times. This

means also that the carrying charges on the loan are 25 per cent more than they would be if the corporation borrowed only what it needed. On the other hand, the bank justifies the 20 per cent rule on the ground that the exact needs of the corporation cannot be accurately estimated and that a leeway of at least 20 per cent is needed to compensate for probable errors in calculation. Possibly the imposition of various kinds of service charges by banks, together with their desire to obtain good commercial loans, will result either in a relaxation of the 20 per cent rule or in lower interest rates on the loans.

A third rule commonly imposed upon commercial loans is they must be liquidated once a year. It is only in this manner that the bank can satisfy itself that the loan is really short term in character. In administering this rule, banks do not look too closely at the means employed by the corporation to obtain funds with which to liquidate the loan. Presumably, it should demonstrate its capacity to get out of debt by using the proceeds from the sale of its products to repay the loan made for the purpose of buying the raw materials. Actually, a bank loan is frequently repaid from the proceeds of a correspondingly large loan from another bank; from some other kind of a loan such as that obtained from the sale of commercial paper, described later in this chapter; or from some other source such as letting trade creditors wait for their money until bank loans are paid off.

The ability of the corporation to pay off its loan once a year reaffirms its credit standing in the eyes of the bank, and the line of credit is again clear. It should be noted that not all corporations go to the trouble of establishing lines of credit. Their need for bank loans are infrequent and cannot always be anticipated too far in advance. When the need arises, they negotiate with a bank for the amount needed. Even in such cases, the mathematical formulas just described still apply.

It should be noted, however, that with the increasing pressure upon commercial banks to keep their funds working they are more willing than in former years to relax the requirement of clearing all loans at least annually. Indeed, there is increasing evidence of their desire to absorb an increasing share of the intermediate loans that are not expected to be liquidated in a single year. This subject is discussed later in this chapter.

**The Five C's.**—In analyzing a corporation's application for a loan or in establishing a line of credit, the bank is expected to study the five C's: capital, capacity, character, collateral, and conditions. The capital, as disclosed by the financial statements submitted in support of the application, is investigated to determine the resources and the debt-paying ability of the corporation. Current assets and earning ability weigh heavier with the bank than fixed assets. The capacity of the management of the corporation is studied, again in terms of its financial results as shown by its financial statements. The bank is more interested in the capacity of the management

to operate the business efficiently than it is in the amount of its total resources. The "moral hazard" is tested in terms of the general reputation of the management for honesty and willingness to meet its obligations. This element of character is more important for personally owned businesses than for the larger impersonal corporation. Where collateral loans are made, the bank may give most attention to the nature of the collateral and its liquidity. Economic, financial, and even political conditions influence the decisions of banks in granting requests for loans.

In coming to a conclusion concerning any particular application for a loan, the bank includes other elements in its investigations also. The purpose for which the loan is made is important. Banks prefer to make loans where the purpose indicates the least doubt about the liquidation of the loan. The type of business is given careful consideration. A business with which the bank is familiar will naturally receive more favorable consideration than one with which no one connected with the policy-making corps of the bank is acquainted. Even geography plays a part in the granting of bank loans. In one section of the country, loans will be granted readily that would be looked upon with disfavor in another section.

**Discounting Practices.**—One means used by banks to advance funds to corporations is by discounting specific kinds of paper held by the borrowers. In some industries, it is customary to take notes receivable as evidence of indebtedness. In the sale of agricultural implements, for example, where the amounts are relatively large and the terms of repayment are spread over a considerable period of time, it is customary for the seller to take a note from the buyer. Banks are sometimes called upon to discount these notes, endorsed by the owner. In most lines of business, however, it is more customary to sell on accounts receivable rather than on notes. Until recently, commercial banks have been hesitant to make loans on accounts. With ordinary commercial loans decreasing in recent years, more consideration has been given to making installment loans on accounts. The merchant who receives the cash is required to guarantee the payment of the account. Sometimes the bank retains a part of the amount collected as a guarantee fund to protect it against failure to collect other accounts discounted by the same merchant.

A special form of account receivable is the trade acceptance. Trade acceptances are time drafts drawn by sellers on buyers and "accepted" by the latter. Acceptance involves acknowledgment of the debt in writing on the face of the draft. Since such acknowledgment improves the collectibility of the draft, it becomes more marketable. The acceptance fixes a maturity date and thereby facilitates accuracy in forecasts of receipts. This in turn facilitates bank borrowing. As a general rule, trade acceptances reduce losses from bad debts because of the indirect pressure of the bank

through which the acceptance is collected and because recognition of the definite acceptance of the obligation tends toward more conservative commitments. In spite of the fact that the use of trade acceptances facilitates borrowings from banks, business enterprises are hesitant to insist that the buyers of their products make use of them. They create a form of sales resistance that has interfered with their general substitution for the more common account receivable.

For specialized transactions, such as those involving foreign trade, a modified form of trade acceptance has gained considerable popularity. The buyer arranges with his bank to finance the purchase of goods. The bank then gives the buyer a letter of credit which assures the seller that the bill will be paid by the buyer's bank. When the goods are shipped, the seller draws a draft on the buyer's bank instead of on the buyer. Meantime the seller sends the bill of lading to this bank. When the bank accepts the obligation for the payment of the bill for the goods, the seller now has a banker's acceptance which can be discounted at his own bank. In such transactions, it is really the buyer rather than the seller who arranges for the financing. As indicated at the beginning of this paragraph, bankers' acceptances have only limited use.

**Other Types of Short-term Bank Loans.**—To meet the needs of special types of borrowers, banks sometimes make available temporary loans in a general class known as "commodity loans." For business enterprises engaged in the storage, processing, or shipment of standardized commodities that enjoy a wide market, this is a favorite form of borrowing. To secure such loans, bills of lading, warehouse receipts, and trust receipts are deposited with the bank. When the seller ships the goods, he draws a draft upon the buyer and deposits the bill of lading, which is the receipt of the common carrier for the goods, with the draft attached, in his own bank. This bank communicates with the buyer's bank which arranges to finance the purchase for the buyer. The bill of lading thus becomes the collateral for a loan to the buyer. In like manner the warehouse receipt, which is an acknowledgment by the warehouse corporation of its receipt of the goods for storage, may be used by any owner as collateral for a loan from the bank. The trust receipt is a device used by the lending bank which makes the person who receives the shipment under the bill of lading a trustee for the bank. When the merchandise is sold, the proceeds must be accounted for to the bank, which is the legal owner of the merchandise.

In the foregoing discussion, it is understood that the bank must be circumspect both in the selection of its risks and in the kind of goods that it will finance. Highly perishable goods or those which are subject to rapid declines in prices are hardly fit collateral for high-percentage loans by banks. The bank can further protect its interests by lending only a portion of the value of the goods. The amount of margin to be put up by the borrower



will be determined by the kind of commodity financed and by the means of its disposal available to the bank in case of a default in the loan.

**Intermediate Loans.**—In most discussions of the needs of corporations for capital to be acquired by borrowing, there is an assumption that long-term needs can be met by the sale of bonds while short-term needs are satisfied by the use of commercial bank loans. The latter, as described above, are expected to run for 1 year or less. In addition, some business enterprises need what may be termed “intermediate loans” to run for longer than 1 year but not for long enough to justify the formalities and rigidities of a bond issue. With traditional commercial bank-loan demand at a low ebb in recent years, some banks have been experimenting with intermediate loans. Since they are made to business institutions, they are usually unsecured, although it is not uncommon for their contracts to contain protective clauses similar to those contained in debenture-bond indentures.<sup>1</sup> They are normally amortized loans calling for their complete retirement through annual payments on the principal as well as the interest charges. This type of loan has distinct possibilities for advantages to both borrowers and lenders. With greater experience, the problems connected with its use, as they affect both the bank and the borrower, will produce their own solutions.

**Temporary Pledge.**—A corporation caught in an unfavorable market sometimes finds it necessary to change its plans for selling a long-term bond issue and uses a part of it as security for a short-term loan of the tiding-over kind. If its plans for the use of the proceeds of the proposed bond issue may also be postponed, it may elect to forego all new financing in a tight money market. If, on the other hand, it is in the midst of a construction program or has made other firm commitments that it cannot easily change, it may be forced to find new money at once. Pledging its own bonds to secure a short-term loan may be, or appear to be, the lesser evil in comparison with attempting to float long-term bonds in an unfavorable market.

**Trade Credit.**—In addition to commercial bank loans, another much used source of temporary investment in current assets is trade credit which is granted by those with goods for sale to those invited to purchase such goods. Purchase of materials on credit results in increasing the circulating capital of the buyer at the expense of the seller. This is part of the sales process in many industries. Manufacturers find an effective means of disposing of their wares to be the financing of those who retail their products. In addition to sales on credit, trade creditors sometimes extend direct loans of cash to those who handle their lines of goods. Business literature customarily includes such sweeping statements as: “credit is the heart and core of

<sup>1</sup>For a discussion of these loans, see the pamphlet published by Institute of International Finance of New York University, “Term Loans by Commercial Banks,” Chicago, 1939.

the industrial system"; "modern industrial society is a credit society"; "credit is the life blood of commerce and industry." The repetition of such statements in any discussion of the prevalence of credit in the modern business world illustrates the dependence of business upon credit. As soon as industry and trade passed beyond the handicraft and barter stages, credit became indispensable. Modern large-scale industrial and commercial organization and operation would be unthinkable on a cash-and-carry basis. Few business enterprises undertake to operate without resort to credit, both in effecting sales and in making purchases. Some, indeed, without appreciable investment of their own, depend wholly upon commercial and industrial credits in their operating programs. If they can buy on 60-day terms and sell on 30 or for cash, they may operate constantly with other people's capital.

**Influence of Trade Practices.**—The use of short-term credit is cumulative. When consumers of necessities buy for cash, the retailers who supply their needs may discount their bills promptly. This enables jobbers, wholesalers, and manufacturers to minimize their borrowings. If, on the other hand, the consumer of a high-priced machine or piece of productive equipment needs time to pay for it, somebody along the line must finance him. This calls, probably, for the ultimate use of bank credit by the retailer, the wholesaler, or the manufacturer.

**Two-way Relationship.**—This last statement suggests the double meaning of credit. A corporation may buy "on credit" and sell "on credit." The relationship of the two policies has profound effects upon the financial operations of the corporation. If it buys always on terms and sells for cash, its owners will need to invest less in its operations than if it attempts to balance sales on credit with purchases on similar terms. But if it always buys for cash and sells on terms, the owners will need to contribute or take responsibility for the additional capital necessary to carry along the creditors until they liquidate their debts.

**Credit and Sales.**—A credit policy should be an aid to the distribution of the products and services of the corporation. A conservative policy in extending credit may cramp sales expansion and keep down profits. A too liberal policy may reduce profits through credit losses. In attempting to strike a balance, the problem should be approached from a positive rather than a negative angle. Favorable factors should be given full weight, to be offset only by a preponderance of unfavorable factors. Unless the market for the corporation's products is saturated, credit extension may be used as an effective means of sales promotion. Present customers depend upon a continuation of credit policies once established, particularly where competitors offer liberal terms to get their trade.

**Credit and Purchases.**—Whenever a corporation sells its products on credit, it may expect to buy its raw materials in the same way. Its labor expects compensation currently. Its raw materials, therefore, must bear the

brunt of offsetting the credit policies of its sales. Or, on occasion, both labor and materials are financed by bank loans. As was shown in an earlier chapter, however, at least a part of current operations should be financed by permanent investment. Whenever purchases and sales are made on credit, there is always a risk to be undertaken by the creditor. This risk is compensated for by higher prices on terms than for cash. This price differential is generally larger than the interest on bank loans. Corporations with lines of bank credit available to them will do well to buy for cash, take the discounts, and finance the purchases, if necessary, by bank loans.

**Credit and Production.**—Sales and collections may be highly seasonal. The nature of the product may dictate this. Seasonal production, with an alternation of peaks and valleys, is usually more expensive than regularized production. If the nature of the product permits, production, even of seasonal goods, may be spread out and regularized through the aid of credit. Reduced costs may be reflected in reduced prices. These may be offered as special inducements to attract advance commitments, which in turn reduce the risks taken by the corporation that operates in off seasons and stores its products until the buying season arrives.

Products requiring long production periods, whether manufactured on order or for stock, require financing until they can be produced, sold, and collected for. Products of this kind usually represent producers' rather than consumers' goods. The purchaser in turn may depend upon their use to liquidate much of their cost to him. The credit policies used to dispose of such products may involve financial programs quite different from other types of business operations.

**Credit and Markup Margins.**—Where credit losses occur, someone must pay the fiddler. The corporation that suffers them cannot long remain in business unless it can pass the loss along. For that reason, profit margins usually anticipate the proportion of losses to be expected and contain a measure of insurance against them. Markup margins are greater when losses from bad debts and from returned goods are greater, and vice versa. In the absence of effective competition, large profit margins may serve as a cloak to cover inefficient collection practices of the seller. It is not a sufficient answer to advise corporations never to grant credit where large risk is present. The nature of some industries is such that goods can be disposed of in no other way. The ultimate test is the willingness of consumers to buy such products in sufficient quantities to justify their continued production.

**Credit and Financial Limitations.**—The needs of the purchaser form one wheel of the credit bicycle; the ability of the seller to supply those needs is the other. It may be necessary for some corporations to reject sound credit risks because their own financial limitations cannot stand the strain of even small losses. It is easy for a corporation to sell itself out of business—on such liberal credit terms that it has so much capital tied up in accounts

receivable that it cannot continue operations. It must close down until it collects enough of its outstanding accounts to warrant resumption of operations. Strong credit standing is a competitive advantage which may attract the purchases of those unable to pay cash. The weakness of the corporation without such backing may be cumulative. On the other hand, a plethora of credit resources may invite too great credit risks, which in turn may give an artificial stimulus to further expansion that cannot be justified from realizable profits.

**Credit and the Business Cycle.**—A good credit risk today perhaps should be refused tomorrow. Credit standings and even abilities to pay vary with changing business conditions. Credit relations are like dominoes stood in a row. The fall of one may carry all others with it. As long as *A* may reasonably expect to collect *B*'s debt, he can hope to pay what he owes *C*. *B*'s default may affect *C*'s ability to collect from *A*. In times of prosperity *B*'s chances may appear good; at the other end of the cycle, they may be nil.

The paradox of the business cycle in terms of credit has never been resolved. The debtor who makes his commitments on the upswing of the cycle will usually have two advantages as prosperity becomes more apparent: (1) With increasing business and increasing profits, he will usually gain in ability to repay his debt. (2) With the increasing prices that accompany prosperity, he will be apt to repay less than he received, in terms of any unit of value other than the dollar measure of his debt. On the other hand, if he contracts during the high-price period of prosperity a debt not due until depression succeeds prosperity, the debtor suffers from two disadvantages: (1) With lower prices, he must repay more than he received, except in terms of dollars. (2) The increased burden comes at a time when he is least able to meet it because of decreased profits and tight money conditions. Proper credit policies will take these possibilities into account.

**Credit Control.**—Collections may be placed administratively in any one of several departments. Their allocation is not important so long as the credit department is operated efficiently. Credit policies and even the extension of credit to specific customers are of vital importance to several departments. If the treasurer alone determines credit policies, he may underemphasize the ability and willingness of the purchaser to pay the debt when due. He may sacrifice sales for safety. If the sales manager controls credit policies, he may be so anxious to increase sales volume that he will follow the other extreme and sacrifice safety for sales. Both points of view are important and should be represented in the determination of credit policies. A policy once determined must be applied (1) in the selection of credit risks, and (2) in the collection practices adopted to see that these risks live up to expectations. The sales department should not suffer from too rigid collection practices; nor should the finance department be asked to

accept a too liberal supply of delinquent accounts as a substitute for the cash expected and needed.

**Analysis of Risks.**—Presumably before trade credit is granted, an analysis will be made of the credit standing of the applicant. Credit managers select credit risks by the application of two tests: (1) willingness to pay, as evidenced by character; and (2) ability, as evidenced by capital and capacity. An honest man without capital or earning power might be a doubtful credit risk; a man of means with adequate earning power might also be a poor risk if he intends to evade his debts if possible. The quality of a particular credit risk is determined by various investigations, financial and otherwise, which need not be discussed in detail here.

Credit risks are relative. A particular applicant for credit might be acceptable for a line of credit up to \$1,000 but no more. The determination of all credit ratings involves more or less guesswork, but a credit manager will always be more willing to "take a chance" on a small risk than a large one.

External factors are used in classifying credit risks, involving such questions as nature of commodity, amount of competition, location, and class of customers served by the purchaser.

It must be recognized, however, that although the same information that a banker uses is available to the trade creditor it will be used differently. In fact, the trade creditor may have access to some information not possessed by the banker. But the banker probably has less competition. His margin of earnings is relatively low. He dares not take too great chances. The trade creditor is trying to make a sale, frequently in the face of severe competition. He is also trying to create a customer for repeat sales who will be attracted, in part, by favorable credit terms. While the banker is anxious to make acceptable loans, he may have more alternative places for his funds than the trade creditor has possible outlets for his merchandise. His own swollen inventory often dictates his anxiety to dispose of his wares, even on terms that represent what amounts almost to a gamble on ever getting his money out of them. In other words, the trade creditor is frequently influenced by forces that are relatively unimportant in conditioning the decisions of bankers in responding to applications for commercial loans. As a consequence, it is not expected that the trade creditor will make so careful an analysis of risks as the banker insists upon.

**The Cost of Trade Credit.**—Considerable risk is attached to the granting of trade credit. This risk is measured in the amount of losses suffered in the accumulation of bad debts. This loss is a part of the cost of trade credit. Even where little or no losses occur, there is always collection expense involved in preventing sales on credit from resulting in losses. Even a part of the cost of maintaining a credit department should be charged to trade-credit cost. The funds that make the extension of trade

credit possible are worth some return, whether they are borrowed or whether they are a part of proprietorship capital contributions. As an offset to these various costs of trade credit, sellers are usually willing to grant liberal discounts for cash. For example, the common practice of quoting discounts as 2 per cent 10, net 30 days means that if the buyer sees fit to pay for the goods within 10 days after the date of the invoice he is entitled to deduct a discount of 2 per cent from the sales price, but that he is expected to pay the full price at the end of 30 days. This means that for 20 days credit he is charged 2 per cent, or an annual interest charge of 36 per cent. Even a policy of 2 per cent 10, net 60 results in an interest rate of 14.4. This high rate puts both buyer and seller on notice that trade credit is expensive.

The amount of loss from selling on credit varies among industries and with different stages in the business cycle. The time factor in the "aging" of accounts also plays a part. One study of the charge accounts of retail establishments in selling to consumers found the following average loss ratios measured by the time factor:<sup>1</sup>

Age of Accounts	Percentage Depreciation
30 days .....	5
60 days .....	7
90 days .....	10
4 months .....	14
5 months .....	19
6 months .....	37
1 year .....	58
2 years .....	74
3 years .....	83
5 years .....	100

If selling on terms is customary in a given industry, purchasers who discount their bills before their due date may be considered to be following a practice of supplying the seller with circulating capital. The discount they enjoy as a return for this favor is the rent they receive for the use of their capital. In a similar manner, if a customer makes an advance on a contract before the goods are delivered, he is furnishing capital to the seller. Presumably, compensation in some form will be arranged for advance payments when the contract is drawn up.

**Commercial Paper.**—Another source of current assets is the sale of commercial paper. The term "commercial paper" is confined to the sale of unsecured promissory notes by business corporations to commercial-paper houses for resale to financial institutions and other large investors. Sometimes the commercial-paper house acts only as a broker. More often it

<sup>1</sup> Quoted in R. A. Foulke, "Practical Financial Statement Analysis" (New York, 1945), p. 381.

has some capital of its own which serves as the basis for loans from commercial banks whenever it wishes to buy commercial paper for resale. The unsold paper serves as the collateral for the bank loan. Denominations of open-market notes vary from \$1,000 to \$250,000, with few smaller than \$2,500 and few larger than \$50,000. Notes for \$5,000 are the most common. The notes run from 1 month to 1½ years, with 4 to 6 months the most common.<sup>1</sup> Issues of less than \$50,000 are seldom used, since smaller amounts do not warrant their cost. Buyers of commercial paper include commercial banks and trust companies, savings banks, insurance companies, investment trusts, and other business corporations.<sup>2</sup>

The sale of commercial paper is not available to very small corporations. The sizes of corporations making use of commercial paper as a means of raising capital in 1924 and in 1930 are indicated in the following table:

Net worth* (000 omitted)	Percentage of total	
	1924	1930
Under \$250.....	5	1
\$250 to \$500.....	19	10
\$500 to \$1,000.....	25	24
\$1,000 to \$2,500.....	27	33
\$2,500 to \$5,000.....	11	15
\$5,000 to \$25,000.....	11	14
Over \$25,000.....	3	4

\* Beckhart, B. H., "The New York Money Market" (New York, 1932), Vol. III, p. 227.

In the foregoing table it is noticeable that the largest percentage of corporations is found in the net worth range of \$500,000 to \$2,500,000. Small corporations lack the maturity and stability required of companies that are able to sell their paper in the open market. The very large corporations have available more satisfactory sources of capital. It is only business enterprises whose past history warrants a very high credit standing that can sell commercial paper. Since original purchasers expect to make an immediate resale to banks and other investment institutions, they must make sure that the reputation of the issuer for prompt payment of its obligations will make a strong appeal. Purchasers buy such paper from no feeling of loyalty to the issuer, but solely from an impersonal judgment that it is a sound investment.

Most issuers of commercial paper are either manufacturers or merchan-

<sup>1</sup> Greef, A. O., "The Commercial Paper House in the United States" (Cambridge, 1938), pp. 229-231.

<sup>2</sup> *Ibid.*, p. 292.

disers. Among the former are manufacturers of agricultural implements, chemicals, clothing, cotton products, dairy products, drugs, furniture, and leather, metal, paint, and tobacco products. Among the latter are chain stores, department stores, mail-order houses, and wholesalers of dry goods, furniture, groceries, and hardware. Other issuers include warehouses, flour mills, oil refineries, finance companies, stockbrokers, and public utilities.<sup>1</sup> Brokers collateralize their notes with stocks and bonds, and warehouses secure their notes with claims against commodities.<sup>2</sup>

**Advantages of Commercial Paper.**—The advantages of commercial-paper borrowings may be summarized as follows:

1. Commercial-paper houses buy note issues only after thorough investigation of the financial strength of the issuing corporation. This includes the capacity to pay the notes when due. This protects the purchaser of the notes and is, indirectly, an advantage to the borrowing corporation.

2. Local banks may be unable to lend the amount required by the corporation.

3. Wide distribution of the notes may result in lower interest rates than local banks would demand.

4. Commercial paper advertises the issuing corporation in the investment markets and may facilitate future distributions of stocks and bonds.

5. The proceeds from the sale of commercial paper may be used in part to liquidate bank loans and thus improve the credit of the corporation at its local bank.

6. All the proceeds from the sale of the commercial paper are available to the corporation. The 20 per cent deposit rule of commercial banks does not apply here.

7. Commercial banks may find the purchase of commercial paper more advantageous than loans directly to the corporation for the following reasons:

- a. They can buy paper with maturities to suit their convenience.

- b. They can diversify their risks both as to types of business and geographically.

- c. They can rediscount commercial paper through the Federal Reserve system if they need liquidity.

- d. They are under no obligation to renew the paper at maturity.

**Disadvantages and Limitations.**—Among the more important disadvantages of open-market borrowing are the following:

1. Free use of open-market borrowing may cause corporations to neglect bank-credit lines. The latter are available only to corporations that use them. Banks are probably more dependable in crises than are commercial-

<sup>1</sup> Greef, *op. cit.*, pp. 243-244.

<sup>2</sup> *Ibid.*, p. 225.



paper houses. A corporation should use the sale of commercial paper as a supplement to bank loans; not as a complete substitute therefor.

2. Open-market borrowing is not available to new businesses that do not have established credit ratings, to small businesses whose borrowings would not justify the costs involved in investigations, to businesses with slow turnover of merchandise, or to those enterprises which sell on installments.

3. Sometimes the total cost of open-market borrowing exceeds that of bank loans. This is particularly true when paper is not readily salable.

4. The commercial-paper house is more nearly a "fair-weather" source of circulating capital than are banks which have more personal relations with their clients.

**Decline in Popularity.**—In one form or another, commercial paper has been used in the United States for nearly a century. It reached its peak in volume in 1920. In the decade that followed, many corporations that had been large issuers of commercial paper became lenders of their accumulating surpluses rather than borrowers. Banks used their resources to finance mounting transactions on security exchanges and security affiliates, thereby diminishing their interest in the purchase of commercial paper. Changing merchandising policies which encouraged the use of finance companies, mergers and consolidations that provided their own financing, and increasing use of acceptances also helped to curtail the use of commercial paper.<sup>1</sup>

The decline in the use of open-market commercial paper is indicated by the following statistics: In 1920, 4,395 firms made use of this means of financing their operations, with average borrowings of \$608,000 and with average outstandings per year of \$2,671,000; by 1929, the number of firms had decreased to 1,653, with average borrowings of \$468,000 and average outstandings per year of \$773,000. Over the 10-year period, a smaller number of companies used commercial paper; those using it borrowed smaller amounts; and they used it less frequently.<sup>2</sup>

According to the reports of the Federal Reserve authorities, the use of commercial paper during the decade of the 1930's was only about one-third as great as during the preceding decade. The decline was almost continuous from 1920 to 1932, with some recovery since the latter year. The future of its use is not promising. Since the factors that have caused the decline over the past two decades will probably become more marked rather than less, it does not appear that there is sufficient reason to warrant an expectation of a resumption of the former popularity of the use of commercial paper.

<sup>1</sup> Martin, B. F., *Recent Movements in the Commercial Paper Market*, *Harvard Business Review*, April, 1931, pp. 360-370.

<sup>2</sup> Beckhart, B. H., *op. cit.*, Vol. III, p. 229.

**Finance Companies.**—Finance companies supply cash by discounting or buying accounts and notes receivable and acceptances. They also aid both wholesale and retail financing of durable commodities of high value, such as automobiles, agricultural implements, electrical equipment, furniture, radios, and musical instruments. The cost of obtaining cash from finance companies is usually much higher than the cost of bank loans. This source of funds is used by small companies that do not have strong credit at banks and by corporations whose aggressive sales volumes are out of proportion to their invested capital. Such concerns may look to finance companies as their financing departments and are willing to share profits liberally with them.

The rapid growth of finance companies is both a cause and an effect of a corresponding growth in installment selling. When banks looked with disfavor upon the installment financing of automobiles, for example, an opportunity was presented for the organization of a new system of financing. The widespread use of the facilities of the finance companies has made possible both the provision of consumer credit and the financing of the production and the distribution of the merchandise that has entered into installment selling. Generally speaking, the finance company relieves both the wholesaler and the retailer of financial worries by financing their operations for them. The consumer who is dependent upon their services does most of the worrying. Insurance relieves the finance company from some losses it might otherwise incur.

While commercial banks have been hesitant until recently to make installment loans of the type that has caused such rapid growth of finance companies, they have not hesitated to finance the latter. The typical financial plan of automobile finance companies, for example, shows that approximately 60 per cent of their funds comes from commercial banks and commercial paper houses and that the other 40 per cent comes in about equal proportions from the sale of debentures, common stock, and preferred stock and from the reinvestment of earnings.<sup>1</sup> Some finance companies have been organized and are owned by the companies whose products are to be financed. While they have a separate corporate existence with their own financial plan, in effect they constitute the financing departments of the parent companies. The largest of these, the General Motors Acceptance Corp., was a concern with a half billion dollars in installment paper on its books in 1940 and with an annual turnover of approximately three times that amount. Its assets consisted almost wholly of automobile paper. Other finance companies that also specialize in one kind of installment paper may be independently organized and financed. Some that are independent deal in all kinds of installment financing. Some of the latter have a nation-

<sup>1</sup> Huegy, H. W., *The Financial Policies and Practices of Automobile Finance Companies*, *Bureau of Business Research Bulletin* 56, Urbana, 1938.

wide organization with many offices located in strategic cities. The largest of these, the Commercial Investment Trust, had total assets in 1940 even greater than those of the General Motors Acceptance Corp.

**Advantages.**—The finance company has come to occupy a definite place in the business structure. Great risks have been assumed, and mortality rates have been high. The advantages of finance companies to corporations that use them as sources of cash are as follows:

1. They are sometimes the only source of funds for corporations without strong credit.
2. They enable corporations to expand their operations.
3. Banks will not ordinarily assume the risks involved in installment credit. Finance companies are better equipped to handle such business.
4. Finance companies sometimes make loans for longer periods than banks.

**Disadvantages.**—As already noted, costs of financing through finance companies are high. The tendency has been to conceal these high costs rather than to relate them to the risks covered and services supplied. Concealment and resultant indirect methods have brought severe criticism of finance-company operations. The sale or discounting of receivables may injure bank and commercial credit. Creditors of the corporation may view these practices as signs of weakness and contract their credit extensions accordingly. Because of this attitude on the part of creditors, concealment of the practice is common. Such deception may have undesirable results. The general practice of discounting receivables may lead to careless acceptance of credit risks.

In recent years, more commercial banks have been willing to compete with finance companies in the making of personal loans, both for the financing of installment purchases and for other purposes. The impetus for such change of attitude on the part of commercial bankers stems from two sources: the increasing difficulty in keeping their resources employed profitably and the record of favorable experience of finance companies. Over the years, the experience of the finance companies has taught them what down payment to demand from the purchaser, how many months to allow for the payment of the balance, etc. All this experience is at the disposal of their competitors. It is to be expected that, in making installment loans, banks will be even more careful than the finance companies have been in the selection of their risks.

**Miscellaneous Sources.**—In addition to the sources of circulating capital noted above, a variety of less commonly used sources are available under some sets of circumstances. For example, in holding-company systems, subsidiaries are often supplied with circulating capital by their parent corporations, usually under some such label as "advances from affiliated companies." Such advances tend to become confused with those made for

other purposes, such as the financing of the fixed capital needs of the subsidiary. Whether advances from parents to subsidiaries are capitalized or not, *i.e.*, whether the parent corporation accepts stocks or bonds in return, they are frequently long-term in character. Other sources of circulating capital include note brokers and other dealers in short-term paper which is extensively used in some industries and not used at all in others.

Some corporations make use of a variety of sources of circulating capital, some of which are nonrecurring. For example, the sale of assets no longer needed in the business may provide much-needed cash. The disposition of slow-moving inventories through the device of special sales and the conversion into cash of other assets, such as marketable securities, may be utilized. Interest and dividends on investments may be useful sources of cash. Short-term loans may be obtained from some of the corporation's officers and directors. Even governmental agencies, such as the Reconstruction Finance Corporation, may come to the rescue of distressed business enterprises by supplying them with cash in emergencies when their usual sources have dried up.

**Circulating Capital and the Business Cycle.**—The oscillations of the business cycle affect both the demand for and the supply of circulating capital. In periods of depression, inventories are contracted, wastes are eliminated or minimized, expenses and costs are cut, and volumes of production and sales are decreased. Price declines affect both the value of circulating capital on hand and the dollar volume needed. When business becomes more prosperous, all these tendencies are reversed: inventories are expanded, wasteful methods of production and distribution creep in, expenses and costs increase faster than production and sales, volumes mount, and prices of both circulating capital on hand and that to be acquired increase.

These changes account for another financial paradox. At the peak of prosperity, when creditors take greatest risks, they are most willing to supply corporations with circulating capital. In the trough of depression, when risks have been reduced, liquid circulating capital is most scarce. At the peak of prosperity, cash has no particular appeal. Other values are as readily accepted. In the trough of depression, everybody seeks to convert all other assets into cash. Liquidity is not only a necessity for many debtors; it becomes a mania among creditors who have no pressing need for cash. Their demands are based upon their fear of losing their equities or of shrinkage in values of all else than cash.

These attitudes profoundly affect the nature of circulating capital. Since cash is not demanded at the peak of prosperity, corporations with large orders and good prospects are encouraged to build up large inventories at high prices, committing themselves to early payment therefor. When depression comes, these inventories "freeze" and shrink in value. But the commitments for their payment have a bad habit of falling due when the

corporation is least able to meet them. What appeared to be wise provision for the future, when the commitments were made, develops into unwise expansion when they fall due. The very success of a corporation, under such circumstances, may be the cause of its failure.

On the other hand, competitive industry leaves no place for the over-cautious business manager. Inability to meet demands for products when needed soon shifts orders to competitors. Both overexpansion and over-conservatism are evidences of bad forecasts. Efficient operation demands careful and accurate determination of future opportunities and needs.

One study of circulating-capital volume found an increase of about 18 per cent from 1926 to 1929 as a result of retained profits, new financing, and mergers. For the same group of corporations, the depression years, from 1929 to 1932, witnessed a shrinkage of approximately 20 per cent in circulating capital. As would be expected, those industries most affected by declines in prices and in business volume recorded the greatest declines in circulating capital. The large amount of cash and marketable securities facilitated the shrinkage during the period studied, without too great embarrassment to the corporations affected.<sup>1</sup>

**Changing Nature of Circulating-capital Demands.**—Financial policies of corporations undergo fundamental renovation from time to time. One of the marvels of the depression of the 1930's was the comparative freedom of industry from failures of large corporations. This was due in large measure to the fact that the preceding bull market witnessed the cleaning up of financial plans of many industrial corporations through the substitution of stock for bonds. With drastic cuts in earnings, many large corporations successfully rode out the storm by the elimination of dividends. The change from bonds to stock eliminated the interest charges. Corporate managers learned this lesson from earlier depressions.

Many corporations were embarrassed in the depression of the early 1920's by top-heavy inventories and heavy bank loans. In the years that followed, corporate managers profited by their mistakes and kept down inventories and bank loans. As a matter of fact, the prosperous years that were enjoyed up to the time of the 1929 break witnessed a new paradox in corporation finance. Prosperity is usually accompanied by increasing dependence of corporations upon bank loans and other short-term borrowings. During the period under consideration, it was customary for corporations to be lenders rather than borrowers. This presented new problems which changed the nature of circulating capital.

**Short-term Credit Extinction.**—Under favorable circumstances, normal business operations are expected to supply the funds necessary to redeem short-term debts at maturity. This argues for relatively small current

<sup>1</sup> Guthmann, H. G., *Industrial Working Capital during Business Recession*, *Harvard Business Review*, July, 1934, pp. 472-477.

indebtedness. Except where short-term borrowing is intended to be a preliminary to long-term financing, the funding of short-term debts is usually an evidence of financial weakness and is accomplished at heavy cost to the corporation. The lender is in a position to dictate the terms. This is true whether the funding is consciously undertaken by an exchange of securities or merely by an extension that is properly classed as forced refunding. Occasionally short-term debts are extinguished by conversion into a longer term obligation. This is more often true when 3- to 5-year notes are held by many investors than when bank loans, for example, are used.

### QUESTIONS AND SUGGESTIONS

1. What are the sources of current assets?
2. To what extent is bank credit used to finance current assets? What changes have occurred in recent decades in the use of bank credit for this purpose?
3. What is a line of credit, and how is it established? What is the 20 per cent rule, and why is it used?
4. Why have banks demanded liquidation of commercial loans at least annually?
5. What are the five C's of a corporation's credit rating? What is meant by the moral hazard?
6. Do you recommend the practice of discounting notes receivable? What are the possible disadvantages of this practice?
7. What are commodity loans? In what types of industry are they used? What are their limitations?
8. What are intermediate loans? For what purposes are they used?
9. Under what circumstances may a corporation pledge its long-term bonds as security for an intermediate loan?
10. What is the meaning of trade credit? Who gains from its use?
11. In what way is short-term credit a two-way relationship?
12. How is the granting of credit influenced by the business cycle?
13. What problems arise in credit control?
14. Who is willing to take greater risks, the banker or the trade creditor? Why?
15. What should be included in measuring the cost of trade credit?
16. What is the meaning of commercial paper? What are its limitations?
17. What are the tendencies in the use of commercial paper? What are its advantages and its disadvantages?
18. What is the function of finance companies? What do you think of their future? Why?
19. What is the effect of changes in the business cycle upon circulating capital?

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#### SUBJECTS FOR INVESTIGATION

1. From current issues of the *Commercial and Financial Chronicle* or from a recent manual, copy the balance sheet of any merchandising or manufacturing corporation. Indicate probable changes that would result from liberalizing the granting of credit to its customers. Show probable changes due to improvements in collection efficiency.
2. From the same source, find a corporation whose balance sheet indicates that it would be a good credit risk. Justify your selection.
3. Select a corporation that you consider a poor credit risk. Justify your selection.

## CHAPTER XXIX

### MAINTENANCE POLICIES

**Integrity of Investment.**—Much attention is given in treatises on corporation finance to expansion policies and to the acquisition of new capital. It is proper that this subject should be called to the attention of security owners and managers. Such programs are spectacular and furnish headline news, at times, to call attention to successes enjoyed by particular corporations. Of equal importance, however, though less spectacular in presentation, is the maintenance of the integrity of the original investment of the corporation and of the security holders' interest therein. It is possible that headline announcements of acquisition of new capital may be smoke screens to hide the failure of corporate managements to maintain existing investments.

**Maintenance and Investment.**—Property investment may be maintained in two ways: (1) by repairing parts that have ceased to have usefulness without rehabilitation; and (2) by reserves for depreciation and obsolescence. The line of distinction between repairs and replacements, on the one hand, and additions and betterments, on the other, cannot always be drawn with accuracy. Many expenditures for plant and equipment partake of a dual nature and must be accounted for under at least two accounts. For this reason, not only the maintenance policies but the procedure of accounting for expenditures are of vital importance to all interested in the financial affairs of a given corporation.

**Repairs.**—Repairs include current expenditures necessary to maintain the normal efficiency of the equipment. They include renewals of small parts of equipment and structures without which the useful life of the capital unit would be unduly shortened. Sometimes a distinction is made between repairs and renewals of parts when the latter tend to extend the useful life of the capital unit beyond its original expectancy. Repairs usually include the replacement of units of capital, such as small tools, whose life is expected to expire within the accounting period. Generally speaking, repairs do not include items that add materially to the value of the assets, nor do they result in appreciable prolongation of their life.

Presumably, repairs are made currently as needed. In practice, however, different corporations follow different policies. There is a tendency among some to let bad-order equipment accumulate in slack periods when it is not needed. Charges for such periods understate expenses and overstate profits



by the amount that should have been spent upon repairs. Starving of maintenance gives a distorted picture of both balance-sheet entries and income accounts.

**Replacements.**—Replacements are installations of new units of plant and equipment to take the place of those whose period of usefulness has expired and whose effective life it is no longer feasible to prolong by repairs and renewals of parts. Where replacements only are involved, the new unit has essentially the same capacity as the one displaced. When replacements occur, the cost of the retired unit should be credited, and the depreciation reserve should be debited—thus eliminating both accounts. The cost of the new unit should be charged to the appropriate fixed-capital account.

This situation offers a fruitful source of juggling of accounts to the confusion and disadvantage of one or more participants in the affairs of the corporation. Sometimes, the cost of the new unit is charged to the proper account, and the cost of the unit retired is not credited. This gives a false appearance of increased investment. Less frequently, retired units are credited to some asset account, and new units are charged to revenue. Such a practice results in the appearance of reduced investment.

**Additions.**—Additions are buildings, equipment, or other facilities added to those already in service and not replacing any already owned. Their cost should be charged to the appropriate fixed-capital account.

**Betterments.**—Betterments are physical changes in plant or equipment that result in improving the usefulness or increasing the capacity of the units affected by the change. It is often difficult to distinguish between repairs and betterments. In many cases, the physical change partakes of a dual nature, being in part repairs and in part a betterment. The expenditure should be divided between the two in such manner that only the part that represents additional investment shall be charged to fixed capital. This is a difficult task and may involve arbitrary decisions. This difficulty is capitalized, at times, when it seems desirable to distort accounts, by charging an undue proportion of the cost of betterments either to the repair account or to fixed capital. Investment may be unduly increased or decreased in this manner.

**Maintenance Policies and the Financial Budget.**—The financial budget should make careful provision for the following expenditures, which may be incurred during the budget period:

1. Ordinary repairs.
2. Extraordinary repairs due to previous starvation of maintenance.
3. Replacements of obsolete or worn-out assets.
4. Additions to plant and equipment and betterments of existing capital.

A carefully planned and well-executed program should enable most corporations to provide for the first three of these without additional investment. The fourth may require new capital. Since the problems connected

therewith involve expansions, discussion of them will be deferred to later chapters.

**Insurance.**—Maintenance policies are profoundly influenced at times by the insurance programs of corporations. By insurance is meant the distribution of risk according to the law of probabilities. Life insurance companies can predict the number of deaths by age groups with a high degree of accuracy. They cannot tell in advance which members of the group will go next. But if all members of the group insure their lives, each will pay for the risk he assumes, and none will cause too great hardship by his death. Corporations have all sorts of risks which they may assume without aid or may share with others. Insurance of these risks burdens revenue with charges for the services that others render in carrying the risks for the corporation. Failure to insure relieves the corporation from such charges but places greater burdens against investment in case of uninsured loss of any kind. Unless the operations of the corporation are sufficiently diversified to provide a proper distribution of risk, self-insurance may mean no insurance. If a corporation's revenue cannot bear the burdens of insurance premiums, its economic justification for existence is doubtful. Few uninsured corporations could absorb losses that may occur to them without severe impairment of capital.

Insurance also has indirect effects upon maintaining the integrity of the investment through the medium of reducing the chances for loss. Merit-rating premiums encourage the installation of sprinkler systems, the protection of machinery against industrial accidents, and the various other devices that reduce the chance of loss and that the insurance companies are willing to pay for in the form of reduced premiums.

**Depreciation.**—In the minds of many people, the term "depreciation" is confused because it is used to describe both the physics and chemistry of property deterioration and the method of accounting for the resulting decline in value. Depreciation from the former point of view is a rather simple phenomenon, easily understood although not easily measured. Property wears out. It wears out from use, and it wears out from lack of use. Indeed, in some cases, deterioration may take place more rapidly from lack of use than from careful use. In any event, depreciation first serves notice of the fact that the property is less dependable than it once was. The something that has been taken away is called, by the engineer, "depreciation" or "deterioration."

As a result of the periodic analysis of the property by the engineer, he reports to the accountant that the value of the property in question is progressively less, disregarding possible changes in the purchasing power of the dollar. The accountant, in turn, undertakes to translate this value decline into a process of record keeping which he also calls depreciation. Hence we are confronted with two different concepts of depreciation: one

1. *Wear and Tear*.—Use of capital, however well repaired and cared for, results in its eventual wearing out and necessitates its replacement. This has been denied at times by those who contend that proper care and repairs are adequate substitutes for depreciation. Upon analysis of such claims, it can usually be found that what is meant is that proper care and repairs can prolong the life of the unit. This is conceded. But physical and chemical changes in any kind of capital equipment are so apparent that they should not require debate.

2. *Action of Elements*.—Whether the capital is used or not, the action of the elements will decrease its value. Iron corrodes, wood decays, and rubber deteriorates. Some capital units may decline in value more rapidly from idleness than from use because, in part, idleness is usually accompanied by lack of proper care and attention.

3. *Accident*.—Injuries sometimes occur to capital units during operation, or otherwise, either through some carelessness or through apparently unavoidable causes. These injuries may necessitate repairs, renewals of parts, or even replacements. The probability of their occurrence should be provided for. Frequently the anticipated cost of accidents is included under the caption of wear and tear, for purposes of depreciation charges.

4. *Inadequacy*.—When new developments or changes in corporate policy occur, specific units of capital may no longer be able to perform efficiently the work intended of them. They may still be useful but lack the capacity to meet increased demands against them. This situation is usually described as inadequacy.

5. *Obsolescence*.—Obsolescence is essentially loss of value due to out-of-dateness. It results from new inventions. When a unit of capital, not yet worn out, can no longer offer effective competition to its rivals, it is said to be obsolete.

Other causes of depreciation, sometimes separately classified but not of sufficient importance to require separate treatment, include negligence, so-called "acts of God," governmental requirements and regulations, and "diseases" such as crystallization and electrolysis.

**Accounting for Depreciation**.—It is the function of the accountant to make proper charges to the depreciation accounts in order that the integrity of the investment may be maintained. Depreciation accounting is never an end in itself. It is only a means to the end of defining accurately what the profits of a given accounting period are. Before there can be any profit, there must first be a maintenance of the investment on the books at the beginning of the accounting period. Small tools that are presumed to be consumed within the accounting period create no depreciation complications. They are completely charged off as an item of expense. It is only those items of capital whose utility units are consumed over a period covering more than one accounting period that are included in any depreciation

accounting. Incidentally, if the traditional accounting period were 25 years instead of one, much of what is considered depreciable capital would become instead ordinary expense items. But since the accounting period is only 1 year long, any item of capital that is not consumed within that period is presumed to be subjected to the depreciation analysis.

It is sometimes said that the accountant is primarily concerned with the creation of a means of providing for a future capital investment. This is hardly the function of the accountant. Instead he is chiefly concerned with the accuracy of reports to management about the maintenance of existing investments. The management may decide not to undertake to replace expiring investments. They may prefer to return the capital to its owners. At the outset, both the accountant and the management are faced with a decision between two alternatives. Shall they keep their depreciation records in such manner that they shall reflect dollar investment or physical investment? For example, if a machine costs \$2,000, shall the records reflect a depreciation allowance that at the expiration of the machine's life will equal \$2,000, or the amount necessary to replace this particular machine at that time? These two alternatives cannot be reconciled. One or the other must be adopted. This constitutes one of the sources of much argument about depreciation allowances.

The depreciation of the dollar investment—\$2,000 in the example cited—possesses the advantages of definiteness and simplicity. Furthermore it is consistent with the thesis of this chapter: *viz.*, that the main function of depreciation accounting is to maintain the integrity of the investment. Any attempt to build a depreciation schedule upon a theory that promises to build up a reserve sufficient to replace a machine at an unknown cost at an estimated future date is not very realistic.

**Depreciation Reserve Not a Fund.**—However accurate the depreciation schedule may be and however carefully it is observed, a depreciation reserve never makes available the funds needed to replace assets. At best, the depreciation reserve is a valuation reserve and is not a "pile of cash in the back room." Only a depreciation fund would ensure the accumulation of cash necessary to replace the worn-out asset. However, it is the expectation that the maintenance of the integrity of the investment will keep the credit of the corporation at levels high enough to justify hope of obtaining the funds needed for replacements as and when needed.

Seldom would a corporation expect to build up a depreciation fund equal to its reserve. As a means of maintaining the integrity of the investment, no depreciation fund is necessary. So long as the equivalent of the original investment is continued in the sum of the capital accounts less the amount in the depreciation reserve, the investment is being maintained. While credits are made to the depreciation reserve from time to time, the cash needed to provide for replacements comes from other sources.

**Depreciation Accounts.**—Depreciation reserves may be stated on the balance sheet in one of two ways: (1) The assets may be carried at cost, and an offsetting reserve on the equities side of the balance sheet may be set up to which annual credits are made. Replacements are thereafter charged to the capital account. Retired units are charged off against the depreciation reserve. (2) The alternative method is to carry the depreciation-reserve account on the assets side of the balance sheet as a reduction from the capital account, the net difference only being carried in the total assets. The latter practice is more intelligible, especially if the depreciation deductions are carried under the respective accounts to which they are applicable.

**Depreciation Base.**—In order to establish depreciation schedules, two factors must be taken into consideration: the dollar value of the asset to be depreciated and the period of time over which the depreciation is to be recorded. There is a growing tendency to classify the assets into groups corresponding to their estimated lives. For example, the Briggs Manufacturing Co. classified its capital assets into numerous groups as follows, each with a different rate of annual depreciation charge:

	Per Cent
Building construction .....	2 to 4
Fencing, paving, foundations .....	7 to 10
Plumbing, sprinklers, electric lighting and power, elevator and heating equipment .....	3 to 8
Compressors, conveyors, and general machinery .....	6 to 15
Ventilating systems, ovens, exhaust and blower systems, flowcoat systems, and spray booths .....	10 to 20
Dry-kiln equipment .....	10
Factory trucks, tables, benches, and racks .....	15
Durable tools and operating machinery .....	8 to 20
Office furniture, fixtures, and machines .....	8 to 10
Dies, patterns, jigs, and fixtures .....	20 to 50

In making a charge of only 2 to 4 per cent for buildings, this company estimates that its buildings will last for 25 to 50 years. Its dies, patterns, jigs, and fixtures, on the other hand, are expected to wear out in 2 to 5 years. This difference illustrates a principle in estimating the effective lives of different kinds of capital. Buildings are usually assumed to have a life measured by time, regardless of the intensity of use. Machinery, on the other hand, is expected to wear out with use. The more the machinery is used, presumably the more rapidly it will wear out.

One difficulty encountered in setting up a depreciation program is the paucity of information about the values of specific capital items. In rare instances, the records would be complete enough to establish the detailed values required. Generally speaking, however, not only must the effective lives of the capital classes be estimated, but their values also. In the

absence of known cost data, each item or class of items to be depreciated must be given a value that is presumably the best approach to a reconstruction of the missing information about their actual cost. Then if the capital has been used for some time before a depreciation program is set up, there must be deducted from the reconstructed cost the value of the portion of the capital item's utility that has already been consumed. Further complications arise from the purchase of plants already completed. The price paid covers land and buildings, without perhaps any careful differentiation between them. Yet in many instances it is assumed that land values do not depreciate. Therefore a separation must be made to determine what part of the cost of the plant is to be assigned to the building that is subject to depreciation.

The policy illustrated above in the experience of the Briggs Manufacturing Co. is by no means universal. A great many business managements reason that, at best, the whole depreciation program is based upon an estimate. In the absence of actuarial experience concerning the effective lives of capital items, this estimate may be little more than an honest guess. Therefore, they reason, a series of guesses may be no more accurate than one over-all estimate that does not attempt to classify capital items into equivalent-life groups. Such analysis usually leads to the conclusion of having a single depreciation base that represents the value of the total capital to be depreciated.

**Depreciation Rate.**—Whether a single depreciation base or a series is used, some one—presumably the engineer—must take responsibility for estimating the life or lives of the property to be depreciated. Once the base has been calculated and the effective life estimated, there remains the job of applying the rate to the base in building up the depreciation reserves. Here there are several possibilities. The simplest is known as the straight-line method. It assumes, for record-keeping purposes, that the amount of value loss is constant year by year. For example, assume that the value of a machine is \$2,000, that it is expected to have an effective life of 10 years, and that it has a salvage value of \$100 at the end of that period. The annual charge for the depreciation of this machine would be  $\$1,900 \div 10$ , or \$190.

Objections are frequently raised to the use of the straight-line method on the ground that the value decline of the capital item probably never follows a course defined by the straight-line method. It is contended that some assets decrease in value more rapidly during the early years of their life, while others decrease more rapidly during the latter part of their life. Some machines wear out most rapidly with intensity of use. The straight-line method possesses the virtue of simplicity and of easy calculation. Few would contend that it ever attempts to measure accurately the actual value-decline experience. On the other hand, it is doubtful if any of the proposed

refinements are based upon sufficient recorded experience to justify the degrees of accuracy claimed for them. Since approximation is required in any event, the simplicity of the straight-line method has much to recommend it. What is most important for the immediate future at least is to get corporate managements to recognize the need for consistently following some system of depreciation. Once that is accomplished, refinements of methods of recording value declines may be given more study and may be subjected to greater experimentation.

As an alternative, some prefer the sinking-fund method of computing depreciation. The application of this method would provide for smaller charges in the early years and heavier charges in the later years of a capital item's life. Other methods permit the depreciation charge to be figured as a percentage of gross earnings; a fixed rate per unit of output; an annual charge that covers both maintenance and depreciation, which means that when more is spent for maintenance, less is reserved for depreciation; a retirement reserve program that seeks to make the amount in the reserve meet its requirements by the time the capital item is retired, but without being sure of sufficient charges to earnings each year; or leaving depreciation charges for any year entirely within the discretion of the management.

**Depletion.**—Depletion should be distinguished from depreciation, although the two are related. It should be noted that some corporations with wasting assets carry a single account called depreciation and depletion reserve. Depletion refers to the exhaustion of natural resources such as gas, minerals, or timber. It represents the removal and disposal, piecemeal, of the corporation's assets rather than the gradual decline in value due to use or the passage of time. Depletion policies are usually governed by the unit of production basis. Where it is expected that the exhaustion of one wasting asset will result in its replacement, depletion reserves may be provided for. For example, the Anaconda Copper Mining Co. provides a depletion allowance for its coal mines, timberlands, and its clay and phosphate deposits but, except for taxation purposes, it makes no allowance for the depletion of the minerals that it mines. Since this company considers that the value of its metal-producing plants is limited to their use at their present locations and in the exploitation of the wasting assets to be found there, it depreciates them also on a unit-of-production basis.

**Depreciation Policies.**—It was pointed out earlier that the particular depreciation policy to be followed by a specific corporation must be established by the management. The engineer and the accountant can advise, but the management decides. Corporations follow various policies in recognizing depreciation and in providing means of offsetting it. Whatever the details of specific proposals adopted, the results may be classified into three groups which may be designated as proper charges, undercharges, and overcharges for depreciation. Probably few corporations deliberately adopt

either of the latter policies. As a matter of fact, charges vary from time to time, with excessive deductions one year and insufficient provision in another. Since the student of finance is interested in results of such charges, it is proper to define depreciation policies as herein outlined.

For a number of years, Park and Tilford, Inc., have pursued a policy of charging off against current operations its expenditures for fixtures, machinery, and equipment in lieu of charging depreciation on this class of assets. As a consequence, it carries in its balance sheet for the item machinery, fixtures, etc., only \$1. Meantime, for the item Tintex, good will, etc., it carries \$2,000,000 with total assets of \$8,583,841. Until 1934, the American Car and Foundry Co. carried no depreciation account, assuming that annual renewals, replacements, etc., kept the plant and equipment in good working condition. In 1934, all the properties were reappraised for the purpose of establishing a depreciation base, the officials of the corporation having decided it advisable to make annual charges to depreciation thereafter. Prior to 1934, the Boston Edison Co. had no depreciation policy. At the end of each year, it credited to a depreciation account whatever amount was authorized by the executive committee of the board of directors. In 1934, at the suggestion of the Department of Public Utilities, it adopted a more definite program.

The Pittsburgh and West Virginia Ry. Co. sets aside no specific amount for depreciation other than on equipment. When buildings are destroyed by fire, the cost, less insurance and salvage, is charged to profit and loss. When property is replaced because of general deterioration, the cost, less salvage, is charged to operating expenses. When ties are renewed, their cost is charged to operating expenses. When heavier rails are installed, the cost to replace in kind, less salvage, is charged to operating expenses; the excess is charged to additions and betterments. The depreciation policy of the Blaw-Knox Co. is based on cost values that would be taken on normal operations of each plant, modified by the percentage at which each plant is operated during the year.

**Proper Charges.**—Proper charges to depreciation result from a careful analysis of the causes thereof for a particular corporation, followed by rigid adherence to a schedule of charges that will properly reflect the effects of such causes. Neither of these assignments can be followed easily. Determination of causes is difficult. Depreciation is essentially an actuarial problem, but the experience upon which actuarial conclusions must be based is usually inadequate or may be wholly absent. Nevertheless, attempts must be made to determine the effective life of each unit of capital, if proper depreciation charges are to be made. Estimates can be made of the effects of the causes mentioned above. Some of these can be made with considerable confidence in their accuracy. Others, particularly those dependent upon economic and industrial developments still in the making, can be only



guessed at. This is especially true of obsolescence and inadequacy, for instance. Experience should be used to forecast the future. At any rate, the recognition of the possibility of changes would help to steer corporations away from the rocks that frequently wreck them.

When the probable causes of depreciation for a particular corporation have been determined and a plan has been set in motion to account for their effects, the only proper method of accounting for such effects is to relate charges against revenue on account of depreciation directly and definitely to them. All other variables ordinarily used are irrelevant. The purpose of depreciation charges is to maintain the integrity of the investment. Proper charges as herein outlined accomplish this purpose. Any other relationship may accomplish other purposes, some of which may be desirable and commendable, but they do not maintain the integrity of the investment. Unless this is accomplished, corporation managers are often misled into erroneous financial policies, and the stockholders and creditors are deceived by the published statements of the corporation.

**Undercharges.**—Some corporations fail to account for depreciation. Two conditions account for this: either the subject is ignored without consideration, or it is assumed that appreciation offsets depreciation. Appreciation may be present, and it may be in sizable proportions. But there is no necessary and direct relationship between appreciation and depreciation. The latter is an accomplished fact, present wherever capital goods are used. It should be accounted for as outlined above. Under favorable circumstances, appreciation may be present. Even then it must be realized upon before the corporation can safely account for it. When accounted for, it must stand on its own merits and not be entered as an offset to depreciation. The same principles are involved when it is assumed that new construction offsets depreciation on other property. Mathematically, this may be true. Occasionally, even, the new construction might be charged to revenue instead of to the capital account. This practice would strengthen the claim to letting it offset depreciation. But again, the two practices are unrelated and should be accounted for separately, each according to the principles of valuation involved.

Other corporations render only lip service to depreciation. They make a gesture in its direction by setting up an account under that label. The charges thereto may be entirely inadequate, or they may be governed by variables that are unrelated to the true purpose of a depreciation account. Especially where depreciation charges are related to earnings, gross or net, or to dividends, they are bound to be too small when adversity hits the progress of the corporation. At such times, losses are minimized or profits increased by omission or reduction of depreciation charges. It takes courage on the part of corporation managers to maintain depreciation schedules in the face of declining earnings and reduced dividends. And yet failure to use

such courage results in misrepresentation of the financial condition of the corporation.

**Overcharges.**—At the other extreme, the depreciation account is used as a cache to hide earnings. When a board of directors wishes to avoid demands from stockholders for increases in dividends, the depreciation account affords one means of accomplishing the desired result. Such actions may be with the best of intent on the part of the directors and may at times serve the long-run interests of the stockholders. Overcharges to depreciation do not merely maintain the integrity of the investment—they increase it without accounting for the increase.

When excessive charges are made for depreciation, earnings for the current period are understated. But by writing down the assets through the depreciation reserve, the earnings ratio of succeeding years will be correspondingly inflated. Stockholders and prospective purchasers of stock may be deceived both when the overcharge to depreciation is made and later when it is reflected in subsequent overstatement of earnings ratios. Even the tax collector influences the depreciation pattern. If a corporation can show a smaller net income by overcharging depreciation, it may keep down its income-tax charges. And of course in public utility regulation, the depreciation charge is a favorite place to hide excessive earnings which would otherwise appear to justify a lower rate for the services. In dealing with both the income-tax collector and the public utility commission, however, there will be a day of reckoning later, when future earnings are computed on a rate base made lower by an overcharge to depreciation.

**Deferred Depreciation.**—Some corporations pursue a policy that may be called “deferred” depreciation. They set up no depreciation account; but, upon the retirement of a unit of capital carried on the books at a considerable amount, they provide for its amortization over the succeeding years by charges against revenue. While this provides a means of writing off the asset, it does not meet the demands of a proper depreciation policy—it does not maintain the integrity of the investment. The Consolidated Edison Co. of N.Y., Inc., follows a policy that may be described as deferred depreciation. Making no depreciation charge as such, the company has created a retirement reserve to which is transferred an appropriate amount whenever any loss is suffered by the retirement from service of any item of fixed capital (except land).

**Railroad Experience.**—Other corporations pretend to find depreciation accounts unnecessary because of their replacement policies. If the assets are divided—as in railroads, for instance—into a very large number of uniform parts that are constantly being replaced, the claim is made that replacements take the place of depreciation charges. The fact is that railroads are habitual sufferers from maintenance starvation whenever revenues

are reduced. Their replacement policies do not maintain the integrity of their investments. Until 1907, railroads made no pretense of accounting for depreciation. For the next 7 years, the Interstate Commerce Commission requested only that reserves be accrued on equipment. Complete adoption of depreciation reserve accounting for railroads was postponed until 1931. The theory of maintenance and replacements of composite property, adhered to by the railroad managements in their opposition to a depreciation policy, has not been sustained by their practice. Had a consistent maintenance policy been followed, the railroads could have made replacements from the charges to expense, thereby avoiding the cumulation of fixed charges on capital borrowed for such purposes. Since the original purchases were made from the proceeds of bond sales, consistent depreciation policies would have facilitated bond retirements, leaving the railroads in stronger financial condition to borrow at a later time when they particularly need new capital to enable them to compete with other carriers.<sup>1</sup>

**Bond Sinking Funds.**—When a corporation issues bonds for the purpose of acquiring assets, it sometimes assumes that the sinking fund set up for the purpose of providing for the redemption of the bonds at their maturity takes the place of a depreciation reserve. This is an erroneous assumption. The corporation undoubtedly has other property not acquired from the proceeds of the sale of the bond issue. Such assets will decline in value over the years, and the bond sinking fund will not provide for their replacement. Even the assets acquired from the proceeds of the sale of the bond issue will have some value after the bonds have been retired. To be sure, there is a relationship between bond sinking funds and depreciation reserves. But the two are not synonymous and should not be considered as substitutes for each other. Where they are not kept separate in corporate planning, earnings are likely to be distorted. The best plan is to consider them as two separate and distinct programs with proper accounting procedure to care for both.

**Intangibles.**—Intangible values are subject to periodic decline the same as are values of physical assets. In fact, many intangible values, such as those represented in patents, franchises, and leaseholds, expire with time regardless of their use. Such assets, if carried on the books at more than nominal amounts, should be amortized, since they cease to have value when the rights granted by them expire. Since time is the essence of their value, time alone should govern the charges to the accounts that represent them.

Other intangibles, such as trade-marks and good will, do not expire with time alone. It is generally agreed that good will which costs money should be entered on the books as an asset. There is not the same agreement

<sup>1</sup> Koontz, H. D., *Depreciation Policy and Financial Structure in American Railroads*, *Harvard Business Review*, Summer, 1936, pp. 460-470.

about entering good will that the company creates for itself. In either event, conservative accounting practice recommends that the account be amortized as quickly as possible. Here, however, we encounter one of the financial paradoxes. If profits are high enough to justify the existence of the item on the balance sheet, why write off good will at the expense of the profits that it creates? When the present F. W. Woolworth Co. was organized in 1911, considerable criticism accompanied the issuance of stock against good will. Yet in 1912 the company earned \$8.73 per share on all its common stock and in 1913 redeemed its 7 per cent preferred stock from earnings.<sup>1</sup> On the other hand, if profits are negligible or absent, this indicates that good will is probably not justified; but the corporation would then have no profits against which the good will, which does not exist except on the balance sheet, could be written off.

Some balance sheets make impossible the determination of the value of intangibles. At the beginning of 1937, the following illustrations were typical: With total assets of \$45,000,000, American Steel Foundries carried plant and good will at \$30,000,000. With total assets of \$18,900,000, the American Window Glass Co. carried profit and good will at \$17,200,000. With total assets of \$9,000,000, the White Rock Mineral Springs Co. carried property, good will, etc., at \$7,000,000.

**Obsolescence.**—In discussing the causes of depreciation earlier in this chapter, obsolescence or out-of-datedness was included without further discussion. Perhaps this idea should be developed a bit further. Obsolescence differs from the decline in value that results from wear and tear, because an obsolete capital item might be as useful as it was the day it was made, assuming a continuation of the same processes, and still be worthless to its owner. The development of more efficient substitutes, changes required by governmental action, and other causes may bring about a condition that absorbs the economic value of a machine or any other capital asset while it is still physically sound. The fact of obsolescence no one questions. We see evidences of it all about us. It is more pronounced in the newer, highly competitive industries than in those whose processes are well standardized and whose control is concentrated.

Changes in airplane models and in the methods of producing them have been very frequent. In the automobile industry, one of the sources of new business has been in making use of forced obsolescence of models—the production of annual models so different in appearance from their predecessors that the car owner wants the new model. On the other hand, changes in the railroad industry have been relatively infrequent until the recent search for the means of survival in the face of competition from the automotive products. But throughout all industry, obsolescence is to be found in vary-

<sup>1</sup> Phillips, C. F., *A History of the F. W. Woolworth Company*, *Harvard Business Review*, Winter, 1935, pp. 225-236.

ing degrees. Even in the railroad industry it has been traditional that few rails, for instance, have ever worn out. They have been replaced by heavier rails before the wearing out process was completed.

This suggests that, along with obsolescence, perhaps we should emphasize a bit more the element of inadequacy. The capital asset may be in style and it may have left many years of usefulness at the level of its original installation. But it may be necessary to replace it with a unit of greater capacity because it is no longer economical to use the smaller unit. In the production of electric power, it has been customary to replace small machines with larger ones of essentially the same character because of the increasing demands for energy produced at a lower cost. While perhaps there is a logical distinction to be drawn between obsolescence and inadequacy, they may be treated together for the purposes of this discussion.

**Accounting for Obsolescence.**—By the use of hindsight, it is easy to recognize the influence of obsolescence in American industrial development. Unless we are to assume that there will be no further progress in the future, we must expect new methods and new inventions to produce further obsolescence. It is the difficulty of forecasting specific changes and particularly of timing them that creates engineering and accounting problems. In discussing depreciation, it was pointed out that the value of the capital asset to be depreciated and its estimated life form the material for depreciation policies and practices. The value is either known or it can be calculated in some way or other. The life expectancy can be forecast with more or less accuracy, assuming that the asset will be used until it wears out or is replaced by another one of similar character.

But when an attempt is made to estimate the time when a different type of asset—at present nonexistent, of unknown and unpredictable cost—will be substituted for any capital asset, complications accumulate. In other words, both engineers and accountants feel quite helpless in attempting to set up obsolescence allowances. The practical difficulties in the path of forecasting future technical changes appear to be so great that separate obsolescence allowances are seldom set up. Nevertheless, recognition is given to the probability of future improvements that will speed the replacement of existing capital installations before the normal time of their retirement. Such recognition takes the form of including in depreciation allowances something that can be used to take care of obsolescence and inadequacy. In very few instances is there any attempt to compute these additions in terms of specific improvements to be installed at designated times. Where obsolescence and inadequacy are given any attention in the calculation of depreciation charges, they are umbrella-like in character. Those who are responsible for their inclusion hope that they will cover any needs that may arise. It is probable that changes made necessary by obsolescence and inadequacy can be anticipated with more accuracy than is now assumed by

many corporate managements. At least some corporations suffer less from the resultant changes than do others, indicating that some managements at least are aware of imminent improvements in technique.

**Writing Off of Assets.**—Closely akin to the subject of maintenance policies is the practice of writing off of asset values. An industry that produces a product which has only fleeting appeal to the buying public may find its investment worthless as soon as the public fancy is directed to some alternative fad. A few years ago a new game known as miniature golf caught the imagination of amusement seekers in many communities. For a single season, this was a very popular game. At the end of one season, most of the investment was worthless. Unless the investment was written off from the profits of a single season, the part not written off represented an almost total loss. The same is true of the capital specifically invested in the production of a play or a motion picture.

To a somewhat smaller extent, some of the investment made necessary to meet the needs of a war must be written off while it is being used for war purposes or it may cease to have value. Some contractors who supplied materials for the conduct of the First World War were able to obtain a sufficiently wide margin of profit to permit a complete write-off of their investment before the war ended. Others were induced to expand their capacity to the point where they found much of it idle when the war ended but without having been able to write off its cost from war profits. Memory of subsequent experiences caused many industrialists to hesitate to expand their plants at the outbreak of the Second World War. Some even insisted that the additions be financed in some manner by the United States government. It will be interesting to see what consequences may flow from this practice. In order to save materials and to minimize losses from obsolescence of new plants made necessary by the Second World War, the Defense Plant Corp. built structures with an expected life of 7 to 10 years.

Occasionally, a corporation authorizes a writing down of the book value of assets for quite another purpose. Suppose, for example, that a corporation with assets of \$1,000,000 followed a practice of charging an average of 4 per cent annually for depreciation. The charge would be \$40,000 per year. Suppose that its earnings, after depreciation, amounted to \$5 per share for 10,000 shares. If it now writes down its assets to \$500,000 and makes a 4 per cent charge for depreciation, or \$20,000, its earnings per share would become \$7, assuming that the actual amount earned did not change. In other words, the smaller the depreciation base, the higher the earnings per share, all else remaining the same.

**Added Investment.**—In the discussion of depreciation, it was recommended that an attempt be made to maintain the dollar investment in the capital of the corporation. From this it would naturally follow that any additional funds needed to replace an inadequate capital asset or one that

had become obsolete must come from sources not accounted for by depreciation reserves. In the same manner, added investment made necessary by changes in the price level must come from other sources. If the dollar investment in the corporation's capital is increased for any reason, accumulated earnings, the proceeds from the sale of stocks or bonds, or some other source must be utilized. In other words, it is the recommendation of the present writer that maintenance policies be not stretched to cover the speculative consequences of changes in price levels. To be sure, a stockholder who receives a dividend in a period of rapidly rising prices may find that his capital is worth considerably less than he thought it was. If so it need not be due to the dividend. Even if no distribution had been made, changes in the level of prices may result in his inability to liquidate his equity, in terms of anything but dollars, for the commodity equivalent of his original investment. It is neither practicable nor theoretically sound to expect maintenance policies to adjust themselves constantly to a changing price level.

### QUESTIONS AND SUGGESTIONS

1. What is meant by maintaining the integrity of the investment? How can it be maintained?
2. Differentiate between repairs and replacements.
3. What is the relationship between insurance and maintenance programs? Is either an adequate substitute for the other? Explain.
4. What part does the engineer play in a depreciation program? What part does the accountant play?
5. What are the causes of depreciation?
6. Why is it necessary to account for depreciation? Are depreciation funds commonly used? Why?
7. Which method of carrying depreciation reserves on the balance sheet do you recommend? Why?
8. Should capital items be classified for depreciation purposes? Why?
9. Why is it frequently difficult to set up depreciation-accounting procedures?
10. What is the straight-line method of accounting for depreciation? What do you think of it?
11. What is depletion, and how is it accounted for?
12. What possible depreciation policies may a corporation adopt? Which do you recommend? Why?
13. Account for the use of policies that result in overcharges to depreciation and in undercharges.
14. What is deferred depreciation? Why is it practiced?
15. What is the relationship between bond sinking funds and depreciation reserves?
16. Should intangibles be depreciated? Why?
17. Why is it particularly difficult to account for obsolescence?
18. What is inadequacy? What causes it?
19. Why are asset values sometimes written off?
20. Suppose that a capital item costing \$2,000 is depreciated for that amount but that its replacement cost is \$2,500. Where does the other \$500 come from?

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## SUBJECTS FOR INVESTIGATION

1. From any manual select 10 industrial corporations. Show for each the ratio of depreciation reserves to the book values of the assets depreciated. What depreciation policy or policies does it appear that such corporations follow?
2. Which of the foregoing corporations carry an obsolescence reserve labeled as such?
3. From any manual (or manuals) see if you can determine the basis of depreciation charges of any industrial corporation by a study of its income statements for a period of several years. To what do depreciation charges seem to be most closely related?



## CHAPTER XXX

### DETERMINATION OF PROFITS

**Confusion of Terms.**—Like so many other words used in law, economics, accounting, and finance, “profit” has no commonly accepted meaning. To the economist, profit is the share of the fruits of industry retained by the entrepreneur. The economist imputes rent to the landlord, wages to labor, interest to the capitalist, and profit to the manager of the enterprise. Since it is not his responsibility to determine the exact amount of profit in any particular case, he is content to deal in generalities. Some economists confuse “income” with “profit” and then proceed to use language that is quite incomprehensible to the practical businessman. One defines income as “a flow of services through a period of time.” Another contends that “all incomes are psychic incomes, the experience of having wants gratified.” It might be a little difficult to compute your income tax with those definitions as points of departure. The financier, on the other hand, is much more interested in the determination of the exact amount of profit available to a particular corporation at a given time. He frequently calls upon the accountant and the lawyer to assist him in this task. Unfortunately, while each renders valuable assistance, there is not always a high degree of teamwork shown by their efforts. When lawyers learn more accounting and accountants more law perhaps present confusion will be cleared up.

In accounting, the word “profit” is used almost invariably with some qualifying word or phrase. In a report of a special committee of the American Institute of Accountants, the word profit is modified in 30 different ways. The most frequently used qualifying words are gross, net, trading, net operating, undivided, and undistributed. According to this report, the accountant usually means by the term profit “the gain resulting from the employment of capital in any undertaking; the excess of the selling price over the cost of anything; pecuniary gain in any transaction or occupation; the surplus remaining from the employment of capital after defraying expenses and providing for loss of capital employed.”

**Importance to Corporation Finance.**—The determination of profits for a sole proprietorship or even some partnerships is a matter of some importance; but, except for the requirements of the tax collector, their exact delineation may cause no great concern. Withdrawals are more likely to be governed by the personal needs of the owners than by the success of the venture, although the latter helps the owners to determine what they consider their

needs. With the corporation, on the other hand, interrelationships among the participants therein and with the state compel more exact calculations. For example, the law frowns upon a declaration of dividends that impairs the capital of a corporation. In some cases, taxes are measured by profits. Equities are dependent upon exact statements of profits. Efficiency is measured in terms of profits earned. Property rights depend upon profit determination.

**Definition.**—By profit, as used in this chapter, is meant net profit. As such, it represents the remainder obtained by subtracting all operating expenses including proper charges for maintaining the integrity of the investment from gross receipts adjusted to provide for probable losses. Profits should be realized before they are accounted for. Profits anticipated may result in losses before the sales cycle is completed. Increases in the prices of assets on hand should not be reflected in the profit and loss statement. Before the goods are sold, they may decline in price. Contracts for future delivery may or may not result in profits. Advance estimates are not always reliable bases for profit determination. As a means of testing the efficiency of various departments, goods in process of manufacture are sometimes transferred from one department to another at a price above cost. Any such "profit" should not appear on the income statement of the corporation at the end of its fiscal year.

Incidentally, there has been considerable discussion in recent years which questions the virtue of accounting for business enterprises by yearly periods. Some contend that, particularly for some features of accounting practice, a longer period might be more desirable. For other purposes, a period shorter than a year has its merits. As a matter of fact, where earnings are computed and reported quarterly or monthly, the comparison of a current period shorter than a year with the corresponding period of preceding years might be very revealing. It is conceivable that it might be even more significant than an annual comparison. However, custom, law, and conventions of one kind or another would make the abandonment of the accounting year quite difficult. Perhaps we can enjoy the benefits of other innovations by continuing to use the fiscal year, supplemented by reports covering both shorter and longer periods.

**Profit and Loss Statements.**—"Income statement" and "profit and loss statement" are used interchangeably. Some corporations use one and some the other. Even the word "statement" is not uniformly used. Some corporations prefer "account" or "summary." Still others use captions different from any of those just named. In the publication of their profit and loss statements, there is a tendency for some corporations to condense the number of items by combining those supposedly of like character. As a general rule, the more condensed the statement, the less intelligible it becomes. A tax collector made a final report in the following terms: "All

paid in; all paid out." Some condensed income statements of business corporations seem to take this tax collector's report as their model. Railroad and public utility corporations make their reports on forms prescribed by the state and Federal authorities that regulate them. Except for the requirements of the Securities and Exchange Commission concerning corporations whose shares are listed on registered exchanges, most nonutility corporations present their profit and loss statements in oversimplified form. Even reports to the commission are sometimes treated confidentially, at the request of the reporting corporations. Generally speaking, the commission has not encouraged the filing of such requests. Both commercial and investment bankers insist upon the filing of much more detailed statements than are usually made public, as a prerequisite to negotiating for financial services to the corporations concerned. Highly condensed and therefore highly inadequate statements may contain as little as three items—gross receipts, expenses, and profit. Elaborate statements may contain as many as 100 items.

**Reliability of Statements.**—Under the best of circumstances, too great finality should not be imputed to profit and loss statements. In a bulletin published by the American Institute of Accountants in 1936, under the title, "Examination of Financial Statements by Independent Public Accountants," appears the following frank statement:

Financial statements are prepared for the purpose of presenting a periodical review or report by the management and deal with the status of the investment in the business and the results achieved during the period under review. They reflect a combination of recorded facts, accounting conventions, and personal judgments; and the judgments and conventions applied affect them materially. The soundness of the judgments necessarily depends on the competence and integrity of those who make them and on their adherence to generally accepted accounting principles and conventions.

Recorded facts should be easily identified. Presumably, wages, cash on hand and in bank, the face value of notes and accounts receivable, etc., are all matters of exact record and therefore should be considered as recorded facts, assuming that they are honestly recorded. The common practice of carrying assets on the books at other than their actual current values is due to adherence to certain accounting conventions. For example, the site of a plant might be worth either more or less than its book value. Conventionally, accountants seldom raise questions about the current values of land. The recording of intangibles at only nominal amounts is an accounting convention. In those realms of accounting practice where exact measuring sticks are not available, personal judgment must be substituted. How much should be reserved for bad debts or even for depreciation? The human equation must weigh heavily in reaching answers to such questions. To make this statement is no criticism of accounting practices, provided

that honesty and sound judgment are present. It is merely a statement of a condition that even the accountant cannot change, however good his intentions.

The problems involving personal judgment seem to be increasing in complexity rather than otherwise. In 1932, a committee of the American Institute of Accountants reported:

From an accounting standpoint, the distinguishing characteristic of business today is the extent to which expenditures are made in one period with the definite purpose and expectation that they shall be the means of producing profits in the future; and how such expenditures shall be dealt with in accounts is the central problem of financial accounting. How much of a given expenditure of the current or past year shall be carried forward as an asset cannot possibly be determined by an exercise of judgment in the nature of a valuation. The task of appraisal would be too vast, and the variations in appraisal from year to year due to changes in price levels or changes in the mental attitude of the appraisers would in many cases be so great as to reduce all other elements in the computations of the results of operations to relative insignificance.

Leading accountants as well as investment analysts recognize the necessity for making income statements as accurate and as informative as the circumstances warrant. While one should not imply that, in financial analysis, attention should be given to the income statement to the exclusion of the balance sheet, nevertheless, from many points of view the former is more relied upon than the latter, at least at a given moment of time. Earnings, both gross and net, fluctuate much more widely and much more rapidly than reproduction or replacement cost of assets. Yet the values imputed to corporate equity securities are much more likely to reflect earnings—present and prospective—than asset values. Indeed, in most instances, asset values are considered to be determined by earnings. Hence the need for care in recording earnings.

**Gross Profit Section.**<sup>1</sup>—Any profit and loss statement is expected to start with the gross profit section. The specific words used depend upon the nature of the industry and upon accounting conventions. In a manufacturing corporation, the initial entry under this section may be called "gross sales"; in a railroad it may be called "operating revenue." In either event, it is expected to include the aggregate selling price of the goods and services disposed of during a given accounting period. Sometimes this item is broken down into cash and credit sales, as a means of credit control. In other cases, a distinction is made between sales to subsidiaries and sales to others.

In order to arrive at net sales, it is necessary to account for returns and allowances. Incidentally, the amount of returns and allowances is frequently a good index of the quality of the service rendered to customers.

<sup>1</sup> Much of what follows is adapted from R. A. Foulke, "Practical Financial Statement Analysis" (New York, 1945), pp. 496 ff.

If large, it represents dissatisfaction on the part of purchasers, whether on account of misrepresentation, inferior quality, or otherwise. Trade and quantity discounts are frequently deducted at this point since they really represent adjustments in sales prices.

By deducting the foregoing items from gross sales, the result is net sales, which is the effective volume of business on which a profit is made or a loss is sustained. It is the key to the computation of most operating ratios such as turnover to inventory, turnover to net working capital, turnover to tangible net worth, and the determination of average collection periods.

The cost of sales includes a variety of items, depending upon the nature of the business. In a manufacturing concern, it would include the cost of materials, direct labor and other manufacturing expenses, real estate taxes on factories, social security and unemployment taxes, and depreciation charges on production facilities. In this computation, the personal judgment of those who determine accounting policies plays an important role. For example, the methods used in valuing inventory may mean the difference between profit and loss for a specific period. Conservative accountants recommend that inventories be valued at cost or market, whichever is lower. At first blush, the willingness to record a loss but not a profit on price fluctuations may seem inconsistent. In some cases, inventory is valued on the basis of "last in, first out." By this means all inventory of any specific kind is valued at the price last paid for any part of it. This practice, it is claimed, eliminates the distortion of profits due to either rising or falling prices.

By deducting the cost of goods sold from net sales, the result is gross profit. The ratio of gross profit to net sales gives the corporation a ready test of its ability to stay in business against its competitors. In every line of business activity, it is possible to establish what may be considered to be normal ratios with which a particular corporation can compare its results of operation. Trade associations frequently make available to their members what may be termed "industry ratios." It is necessary, of course, to make sure that similar methods have been followed in the computation of these ratios if they are to be comparable.

**Operating Profit Section.**—Following the determination of gross profit, numerous other deductions are made before operating profit can be determined. Here there exists a wide variety of practices in reporting general expenses, varying from one all-inclusive item to a breakdown into fifty or more items. In many instances, it is well for management to know that lavish travel and entertainment expenses result in operating losses instead of covering up this fact in a blanket item. In general, operating expenses are expected to fluctuate much less than the production cost of labor and material. When periods of retrenchment arrive, it may not be easy

to cut administrative, selling, and overhead costs as much as other costs. In fact, it may be necessary to increase some costs in the effort to increase sales.

Administrative and general expenses include compensation of officers and others not accounted for under production or sales expenses, depreciation not accounted for elsewhere, telephone and telegraph, etc. Selling expenses include salaries and commissions of salesmen and others employed in the sales department, traveling and entertainment expenses, advertising, etc.

Since it is customary to do business on credit, it is essential that all accounts receivable be reviewed regularly to see which ones are likely to result in loss. If the amount of such loss were definitely known, it could be charged off. Since some accounts are merely slow but good while some others thought to be good may prove to be worthless, provision must be made for probable losses. Reserves for doubtful accounts cause deductions as a part of operating expenses.

By subtracting the sum of administrative and general expenses, selling expenses, and provisions for doubtful accounts from gross profit, the result is operating profit, frequently termed "net operating profit." This figure measures the results of the operating policies of the management in directing its affairs according to the main purpose for which the business was organized. Again results are relative. In a period when most competitors are suffering heavy operating losses, a lesser loss for a specific corporation instead of a profit might be cause for jubilation rather than regret.

**Final Net Profit or Loss Section.**—In small single-purpose business units, net operating profit may be the figure most sought after. But in larger, more complicated business enterprises, other factors must be considered. For example, in small business enterprises, the cash discounts given and received will probably be nominal. Large corporations may have substantial debits and credits in this department. For that reason, it may be desirable to consider them as a separate item. After considering cash discounts earned and given, the result is net operating income from normal operations. Sometimes interest is deducted along with cash discount. For the reasons indicated below, it seems appropriate to treat interest separately.

To this net operating income from normal operations is added nonoperating income from other sources. Where "feeder" companies become "suckers" instead, a loss is deducted rather than an income added. The amount of nonoperating income may be negligible, or it may be very substantial. The sources of nonoperating income are numerous, including dividends and interest received on investments, profits on securities sold, royalties, income from rentals, etc. By adding nonoperating incomes to operating income, the result is total net income.

From the standpoint of financial analysis, it is desirable to deal with interest charges at this point. It is important to determine total net income,

regardless of the ownership of the business enterprise. Suppose, for example, that corporation *A* has only stock outstanding with no interest-bearing debt while corporation *B* has stock and bonds. We can compare net incomes of the two before interest charges and then after deducting interest. These comparisons are frequently vital in evaluating the two corporations. Leverage companies, which find trading on the equity profitable during periods of high earnings, may be hard hit during depressions when fixed charges continue in spite of low earnings. The fluctuations in net incomes is much greater for leverage companies than for those which have no fixed charges in the form of interest. Also, by this procedure, the times earned ratio for interest charges is more readily determined. Should there be charges for bond discount, they should be deducted next. The result is the balance of income before taxes.

Taxes have become a most important consideration for American business corporations. Property taxes, capital-stock taxes, social security and unemployment taxes, etc., have already been accounted for. The most significant tax imposed by the Federal government and by some states is the one labeled tax on corporate net income. When the amount of this tax is deducted, the final net profit or loss for the period is arrived at. This should be the amount earned for the stockholders of the corporation, subject perhaps to certain adjustments to be discussed later. If current regular dividends on preferred stock, if any, are deducted at this point, the remainder is the amount earned for the common stockholders. When regular dividends on the common stock are subtracted, the remainder is the excess of net income over regular dividends (or the excess of dividends over net income in case the dividends are greater than the net income).

**Non-recurring Items.**—Some accountants recommend that extraordinary charges, resulting in adjustments of net income, be made at this point. Others prefer to deduct them earlier, since some of them at least may affect the amount of taxable net income. Such adjustments include losses due to unforeseen contingencies, such as floods and hurricanes. Except for possible tax advantages, it seems desirable to keep out of the stream of current income from operations the results of nonrecurring actions like capital gains or losses and gains or losses from transactions in the corporation's own stock on bonds. When fixed assets are disposed of at prices other than their book values, profits or losses occur, the latter probably more commonly than the former. These profits or losses should be segregated from those resulting from ordinary business operations. A profit so recorded may be only temporary, to be absorbed if and when the asset disposed of is replaced. Taking a loss in the disposition of a fixed asset may be entirely justified, as the price of progress. A usable but inadequate structure or piece of equipment may have become inadequate quickly, because of the invention of a better

machine. Depreciation charges may not have been sufficient to absorb the book value less the sale price, and a loss occurs. But it should not be reflected in current net profit from operations.

Occasionally, owing to changes in accounting procedures, or to error, gains or losses applicable to some period preceding the current accounting year are discovered. They should not be confused with the results of the current year's operations. To permit such confusion might result in unwise financial decisions, based upon erroneous information. Such profits and losses must be accounted for, to be sure. If a loss is discovered, it must be met. If an undisclosed profit is revealed, it may be used for one or more purposes. But the source of either should be identified and its disposition handled accordingly.

**Deferred and Prepaid Expenses.**—Accountants readily recognize the need for providing for both deferred and prepaid expenses in a manner that will represent a true picture, so far as current operations are concerned. Deferred expenses cover present or past charges which are distributed over a period of time longer than the accounting year. Examples are uninsured fire losses, replacements of machinery because of obsolescence or inadequacy against which no reserve has been set up, or heavy legal expenses resulting from long-drawn-out litigation covering several years. Such expenses should not be capitalized permanently, nor should the income of any one year be burdened with the entire charge. Profits may be distorted by the application of either of these two policies.

The opposite of deferred expenses is prepaid expenses. Expenditures are incurred for benefits that extend over future accounting periods. Payment of premiums on fire insurance policies may be for a period of 3 years, in advance. If the entire cost is charged against the gross receipts of the year that witnesses the payment of such bills, profit will be understated for that year and overstated in the years to which a part of the payment applies.

Current tendencies in accounting practice lean in the direction expressed by the American Accounting Association in a bulletin entitled "Accounting Principles Underlying Corporate Financial Statements," published in 1941. In this bulletin appears the following statement of principles:

For any one year the income statement should reflect all realized revenues, and all costs and losses written off during that year, whether or not they have resulted from ordinary operations.

1. The income statement for any given period should be divided into such sections as may be required to show not only particulars of revenues from and the expenses of the operations of the current period, measured as accurately as may be at the time, but also profits and losses from revenue realization and cost amortization not ordinarily associated with the operations of the current period.

With the general principles just stated the American Institute of



Accountants seems to be in full accord. In a bulletin published in 1941, its committee on accounting procedure stated:

Over the years it is plainly desirable that all costs, expenses and losses of a business, other than those arising directly from its capital-stock transactions, be charged against income. If this principle could in practice be carried out perfectly, there would be no charges against earned surplus except for distributions and appropriations of final net income.

As a recent example of the application of the foregoing principle, the "Consolidated Statement of Income" of the U.S. Steel Corp. for 1944 is a case in point. Its items are as follows:

	(000 omitted)	
	1944	1943
Products and services sold .....	\$2,082,186	\$1,972,344
Costs		
Employment costs:		
Wages and salaries .....	902,162	853,266
Social security taxes .....	21,995	26,012
Payments for pensions .....	33,074	33,650
	<u>\$ 957,232</u>	<u>\$ 912,929</u>
Products and services bought .....	792,901	706,763
Wear and exhaustion of facilities:		
Depletion and depreciation .....	81,083	85,163
Amortization of emergency facilities .....	56,765	43,652
Loss on sales of plant and equipment .....	1,149	5,192
	<u>\$ 138,997</u>	<u>\$ 134,008</u>
War costs included above applicable to and provided for in prior years .....	(Cr.) 3,517	(Cr.) 1,123
Estimated additional costs applicable to this period arising out of war .....	25,000	25,000
Interest and other costs on long-term debt .....	4,979	6,251
State, local, and miscellaneous taxes .....	40,801	41,566
Estimated Federal taxes on income .....	65,000	84,316
Total .....	<u>\$2,021,395</u>	<u>\$1,909,713</u>
Income .....	60,791	62,631
Dividends: On cumulative preferred stock .....	25,219	25,219
On common stock .....	34,813	34,813
Carried forward for future needs .....	<u>\$ 758</u>	<u>\$ 2,599</u>

**Inclusion of Surplus Division.**—It is not uncommon in current accounting practices to include in the income or profit and loss statement a division of surplus items which contains the following. The net profit (or loss) as above defined is shown as a net addition to (or deduction from) surplus. To this is added the unappropriated surplus recorded at the beginning of the account-

ing period. Other adjustments are made in the form of transfers to or releases from appropriated surplus, giving an item of total unappropriated surplus. Deductions include those due to acquisition of treasury stock, special or irregular dividends, and stock dividends. The remainder is the unappropriated surplus as of the close of the accounting period.

**Distortion of Profits.**—The writer is not inclined to disagree with the points of view expressed in the preceding sections. The student of finance is interested in results and is ready to accept the recommendations of leading accountants on the best methods of attaining them. In the interpretation of corporate records, it is evident that the recommendations of leading accountants have not always been followed. With the best of intentions, corporate managements and accounting departments may, through errors and miscalculations, understate or overstate profits for any given period. The results may be disastrous if unwarranted expansion is encouraged or if too liberal dividends are distributed. In addition to such under- or overstatements of profits, corporate managements sometimes direct intentional distortion of accounting records. In some cases, no harm is intended by departure from beaten paths. Poor current results, accompanied by better future prospects, may invite optimistic accounting practices. On the other hand, large earnings in the face of poor future prospects may encourage “conservative” current statements in the expectation that the anticipated poor showing for the succeeding period may be eased a bit by so manipulating the books that current operations may absorb a part of future shocks. Or, without any such definite situation facing them, boards of directors may feel that they know best what is good for their stockholders. Consequently, the income statements are made to reflect not current operations, but the management’s opinions of what the stockholders and others should know.

Unfortunately, one may not always be so charitable about the forces that motivate the decisions of corporate directors. Their control over the content of income statements places them in a very advantageous position for manipulating the affairs of their corporations to serve their own selfish purposes. Optimism may be injected into accounts as a stimulant to stock prices; at other times, pessimism may be used as an opiate. It is not sufficient to brand such actions as illegal. They may be; and in many cases they would probably be so declared, if properly prosecuted in courts of equity. The fact is that actions of boards of directors are seldom called into question. If and when they are, directors’ misdeeds are not taken for granted but must be proved. The net result is that profits for any given corporation at any time are essentially what they are determined to be by the corporation’s board of directors. If an ulterior purpose is behind any manipulation of accounts, it is usually accomplished before the true status of affairs is discovered by those whose interests are adversely affected.

**Methods Used.**—Methods of distorting profits are numerous and ingenious. Some distortions are quite innocent and unintentional. Errors or miscalculations may result in either over- or understatements that deceive the management as much as others. Where an intent to deceive is present, it is not difficult to find a means of accomplishing desired results. Concealment of profits is accomplished by overcharges to the various items of expense, particularly the depreciation account, by including betterments in the charges for repairs and replacements, etc. As long as such practices are followed, stockholders suffer from understatements of profits. Sooner or later, the betterments and overcharges to operating expenses may be reflected in increased earnings per share which should benefit holders of securities during subsequent periods. Meantime, the stockholders of the first period, discouraged with the low profits recorded for them, may have sold out to others, perhaps to the insiders who knew the true condition of the corporation's financial affairs and who are in a position to take advantage of the ignorance of the mass of the stockholders.

Reversing the above practices will distort profits in the opposite direction. Undercharges to operating expenses and charges of repairs and replacements to the capital account will make profits appear to be larger than they really are. Stockholders who are deceived by such statements, and others who become stockholders because of their faith in false reports concerning profits, relieve the insiders by the purchase of their stock at high prices. Later, when the false records begin to cause trouble and are followed by adjustments showing the true condition of corporate finances, profits will suffer accordingly. Holders of stock at such times may wish to sell, under circumstances that permit only low prices for their holdings. Perhaps the purchasers are those who sold out at high prices.

**Remaking Income Statements.**—Banks and other financial institutions whose assistance is sought by a business corporation are not accustomed to take too seriously the income statements prepared by the corporation. They frequently find it necessary to rewrite such statements in a manner to make the information presented therein more intelligible and more reliable. Where it is not possible to rewrite such a statement to the satisfaction of the financial institution, with the assistance of the corporation when supplementary information is called for, the financial assistance sought may be denied. The average investor is not so fortunate as the financial institution. He probably lacks the capacity to remake any such statement. His lack of experience may prevent him from even raising questions about the accuracy of income statements, should he take the trouble even to look at one. The printed page, containing figures that appear to have been carefully prepared, is quite impressive to the average reader. The discoverer of Arabic numerals provided the business world with a useful tool, without which the extent of

modern business transactions would be unthinkable. But he also made possible the distortion of the use of this tool to serve selfish purposes at the expense of those who are not experts in its application.

**Comparative Statements.**—Anyone who attempts to analyze income statements needs a telescope as well as a microscope. In addition to a careful analysis of the current year's operations, it is essential to determine how its results compare with those of preceding periods. A comparative statement, showing the results of two or more years, can be presented readily in published income statements. Such a practice would be exceedingly useful to anyone who studies corporate reports. Any changes in accounting practices would need to be noted, probably in footnotes, in order to provide the material for reconciling differences that might otherwise be incomprehensible. Some of the space devoted to "editorials" in corporate reports might well be devoted to the presentation of more factual material instead.

**Supplementary Information.**—If those responsible for the presentation of income statements would occasionally place themselves in the position of the readers of their reports, it is probable that much more supplementary information would be presented. It has already been pointed out that oversimplification may result in making reports unintelligible. It would be interesting to see an income statement that takes little for granted beyond the assumption that the reader will be fairly intelligent, that he will possess a modicum of financial ability, and that he will be interested in the affairs of the corporation. Under such circumstances, the income statement might well be buttressed with copious explanatory notes and supplementary schedules which would really be useful to the reader of the report. In the preparation of such footnotes and schedules the accountant would frequently need the assistance of others.

Because of his thorough acquaintance with the technique of his profession, the accountant sometimes forgets that others may not be so expert as he in the use of his tools. Unlike the surgeon who is expected to conceal his handiwork, the accountant is expected to reveal the results of his labors. To reveal them in symbols that only another professional accountant can understand is not very helpful to the layman. Perhaps it is not possible to interpret accounting statements to one who knows little of accounting science. Yet the effort to do so would be worth a trial. At least the language of accounting could be supplemented by the use of language that is more comprehensible to the nonaccountant reader. Such supplementary information would also be very useful to other accountants who do not have access to the work sheets of the one who prepared the published statements.

**Profits of Subsidiaries.**—Where one corporation owns a controlling interest in a subsidiary, the paying of a dividend by the latter to the former may not represent correctly the interest of the holding company in the profits

of the subsidiary. The dividend may be greater or less than the proportionate share of the earnings. In case the subsidiary is wholly or even substantially owned, a mere report of dividends in the income statement of the recipient may be quite misleading. A footnote might be used to explain the difference. In the other cases, consolidated statements are used to show the effect of the operations of the "system" or, conversely, to hide the results of separate parts of the system by commingling them with other parts. Intercompany transactions particularly are open to manipulations of various kinds, through the device of fixing prices in such manner as to give an unwarranted advantage to either the buyer or the seller. The presence of minority interests may help to determine such pricing policies. A detailed discussion of consolidated statements and their effects would take the present discussion too far afield from its major objective.

**Statistics of Profit.**—The most recent statistical report of profits for all corporations reporting to the United States Bureau of Internal Revenue shows the following:

ADJUSTED CORPORATE NEW PROFITS;  
PERCENTAGE OF STOCKHOLDERS' EQUITY, BY ASSET-SIZE CLASSES\*

Total assets (000 omitted)	Before taxes			After taxes
	1939	1941	1942	1942
Under \$50 . . . . .	-3 4	14.7	19.5	13.5
50 to 99 . . . . .	4.6	18 2	20.0	12.9
100 to 249 . . . . .	6.0	19 6	22 4	12 7
250 to 499 . . . . .	7 3	20.0	23 8	10 9
500 to 999 . . . . .	7.8	20.3	26.0	10.6
1,000 to 4,999 . . . . .	8 2	20.2	26.7	10.4
5,000 to 9,999 . . . . .	8.1	20 4	26.3	10.3
10,000 to 49,999 . . . . .	8.0	17.8	24.7	9.8
50,000 to 99,999 . . . . .	6.7	16.7	20.9	8.8
100,000 and over . . . . .	5.1	11.4	13.8	6.9

\* As reported in *Survey of Current Business*, January, 1946, pp. 12 and 15. Adjusted for officers' salaries.

The table shows that medium-sized business units, with assets of \$500,000 to \$10,000,000 each, tend to earn higher percentages, before taxes, than either the very small or the very large corporations. The column showing the ratio of profits to total assets, after taxes, however, shows that the smallest units enjoy the highest rate of profits, with a progressive decline for every other asset-size class. Before accepting the finality of these figures, one would need to know more about the adjustments that were made from the amounts originally reported.

The *Survey of Current Business* for April, 1946, reports the following amounts of corporate profits for all corporations, both before and after provision for Federal and state income and excess profits taxes.

(In billions of dollars)

Year	Before taxes	After taxes
1929. ....	\$ 9.8	\$8.4
1936-1939 average. ....	5.3	3.9
1940. ....	9.2	6.3
1941. ....	17.1	9.2
1942. ....	21.0	9.2
1943. ....	24.9	9.9
1944. ....	24.1	9.8
1945. ....	20.9	9.1

### QUESTIONS AND SUGGESTIONS

1. What causes the confusion in the use of the term profit? How does the accountant use this term?

2. Why is the determination of profit especially important in corporation finance, in comparison with the financing of a sole proprietorship?

3. What is the meaning of net profit?

4. Which kind of profit and loss statement can be made more intelligible, a highly condensed statement or a detailed one? Why?

5. Who determines the form and contents of income statements? How reliable are such statements?

6. What reservations must be made about independent audits?

7. List several accounting conventions. How do you think they originated?

8. Give several instances of "judgment" items in accounting statements.

9. What is the starting entry in building up an income statement? What various words are used to identify this entry?

10. How important is the net sales entry? What does the cost of sales include?

11. What do administrative and general expenses include?

12. Differentiate between operating and nonoperating income. Give examples of the latter.

13. Why is interest sometimes treated differently in accounting than in corporation finance?

14. What is a nonrecurring item? Mention several.

15. Distinguish between deferred and prepaid expenses, and give examples of each.

16. What are current tendencies in accounting practices with respect to items involving previous periods?

17. What is meant by distortion of profits? How is this accomplished? What remedies have stockholders where profits are distorted?

18. What are comparative statements? Why are they useful?

19. What kinds of supplementary information would assist readers of income statements?

**SUPPLEMENTARY READINGS**

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- KIRSHMAN, J. E.: "Principles of Investment" (New York: McGraw-Hill Book Co., Inc., 1941), Chap. XI.
- LINCOLN, E. E.: "Applied Business Finance" (New York: McGraw-Hill Book Co., Inc., 1941), Chap. XIII.
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**SUBJECTS FOR INVESTIGATION**

1. From a recent manual or other source, find two income statements whose accuracy you have reason to doubt. What are your reasons?
2. Select two corporations whose shares are listed on the New York Stock Exchange. Compare their earnings per share over a period of 5 years with the price ranges of their common stock. What conclusions do you draw?
3. Find two corporations which probably distort their profits. Account for the distortion.

## CHAPTER XXXI

### SURPLUS AND ITS USES

**Meaning.**—Like many other terms used in finance and accounting, the term “surplus” lacks precision of meaning. It is used to define different and even conflicting sets of circumstances. Logically and historically, the surplus account, while being a balance sheet entry, has its origin in the income statement. When a corporation starts operations, presumably its assets are contributed by its creditors and its proprietors. It would therefore have no surplus. At the end of its first year of operations, assuming it to have been successful, it would have something left over from its earnings, after meeting all its operating expenses and after setting up the proper valuation reserves. This amount that is “left over” represents an addition to the assets and is carried on the equities side of the balance sheet under the title “surplus.” Assuming that only a part of this surplus was paid out in the form of dividends, the remainder would be carried along from year to year as accumulated surplus. It would consist of the sum of the leftovers from each of the accounting periods, less any amounts paid out in dividends and less any losses suffered instead of annual gains. Unfortunately, this income statement origin of surplus has little use in the face of other more common conceptions of the term.

One of these meanings gives to the surplus account the doubtful honor of being a nameless sort of account used to cover so many purposes that it is difficult to describe. Perhaps it would be more intelligible if its name were to be changed to “adjustment” account. At any rate it is made up of a variety of leftovers from various accounting entries, of which the original conception of undistributed earnings is only one. Practically, the amount of the surplus is arrived at by an arithmetical exercise. As an arithmetical residual, it describes nothing except to suggest a general idea of something left over.

**Mystery of Mysteries.**—In terms of any particular corporation, surplus is the difference between the book value of the assets and the sum of the liabilities and stated capital. Since each of these original members of the equation is frequently a dark mystery to most, if not all, readers of the corporation’s balance sheet, the derived member of the equation—the surplus—becomes a mystery of mysteries. Intentional and unintentional understatement or overvaluation of assets affects the balance sheet in the same way. At best, asset valuations reflect opinions rather than incontestable facts. Even liabilities are not always correctly stated, nor are they



always definitely known. Stated capital has come to be worse than useless for valuation purposes in many cases. The item of surplus therefore can mean much or little. No single balance sheet can carry its own validation.

**Confusion of Terms.**—Recent corporate practices have introduced terminologies that further complicate any attempts to impute real significance to the surplus account. Current methods of recording surplus by American corporations include the following terms, in addition to those more commonly used:

Name of Corporation	Name of Surplus Accounts
American General Corp. ....	Profit and loss surplus
Bamberger (L.) and Co. ....	{ Appropriated earned surplus
Bausch Machine Tool Co. ....	{ Property surplus
Borg-Warner Corp. ....	Common stock and surplus
Botany Worsted Mills ....	Appreciation surplus
	{ Capital surplus
	{ Reserve surplus
	Unappropriated surplus
Brandtjan Kluge, Inc. ....	Surplus not available for common dividends
	Surplus for preferred sinking-fund require-
	ments
Brown Shoe Co. ....	Unrestricted surplus
Carnegie Metals Co. ....	Contributed surplus
Devonian Oil Co. ....	Revaluation surplus
Foreign Power Securities Corp., Ltd. ....	Appraisal surplus
Frink Co. ....	Distributable surplus
Horne (Joseph) Co. ....	Undivided profits
International Mining Co. ....	Initial surplus
	{ Income surplus
Kennedy's, Inc. ....	{ Investment transactions surplus
Lehigh Portland Cement Co. ....	Reserve surplus
National Paper and Type Corp. ....	Unrealizable appreciation
Paramount Broadway Corp. ....	Unearned surplus
Paramount Pictures, Inc. ....	{ Surplus, July 1, 1935
	{ Deficit since July 1, 1935
	Other surplus
Pennsylvania-Dixie Cement Corp. ....	{ Excess of par value over cost of preferred
	{ stock retired
	Reduced stated value, common stock
Railroad Shares Corp. ....	Capital deficit
Security Title Bldg. ....	Leasehold surplus
Sherman Clay and Co. ....	Reduction surplus
Signode Steel Strapping Co. ....	Contingent surplus
Silesian American Corp. ....	Other surplus arising from the retirement
	of bonds
Western Newspaper Union ....	Organization surplus
Wickwire Spencer Steel Co. ....	Capital and surplus deficit

**Deficit.**—When the equation stated above produces a negative result, the difference is supposed to represent a deficit instead of a surplus. Even this is not always recognizable from the balance sheet. Deficits are some-

times labeled surplus account. Appearing on the assets side of the balance sheet, they make a favorable impression on the uninitiated. Deficits from operations are at times offset by capital surpluses so that the net figure is positive rather than negative. Or they may be camouflaged by combination into one account of stated capital and deficit under the misleading label of capital and surplus. In still other cases, a deficit may be labeled surplus and carried on the equities side of the balance sheet as a debit entry.

Examples of corporations with large deficits—in proportion to their total assets—are as follows:

Name of company	Total assets (000 omitted)	Deficit (000 omitted)
American Metal Co.....	\$ 2,574	\$ 3,006
Arcade Malleable Iron Co. ....	651	270
Bowman-Biltmore Hotels Corp.....	4,000	9,000
Brockway Motor Truck Corp.....	3,503	7,887
Cleveland and Buffalo Transit Co. ....	2,767	1,184
Cramp (Wm.) and Sons Ship and Engine Building Co.	8,000	16,000
International Mercantile Marine Co. ....	27,563	23,376
Lehigh Valley Coal Corp.....	36,338	9,000
Oliver Farm Equipment Co. ....	22,000	25,000
Panhandle Producing and Refining Co.....	2,000	3,500
Peapeke Corp.....	1,457	5,302
Radio-Keith-Orpheum Corp.....	91,000	24,000
Railroad Shares Corp.....	4,589	3,985
Stutz Motor Car Co.....	1,203	7,389
Wickwire Spencer Steel Co.....	25,557	11,564

**English Practice.**—In general, English corporations have simpler corporate surplus accounts and carry smaller surpluses than do American corporations. The J. and P. Coats, Ltd., registered in Scotland, uses carried forward where surplus is commonly used in the balance sheet. Selfridge and Co., Ltd., uses surplus forward where surplus is commonly used.

Name of firm	Total assets	Profit and loss surplus
Anglo-Iranian Oil Co., Ltd.....	£44,808,575	£511,126
Associated Newspapers, Ltd.....	7,655,892	601,032
Anglo-Newfoundland Development Co., Ltd.....	21,748,186	700,256
Boots Pure Drug Co., Ltd.....	7,675,871	298,090
Shell Transport and Trading Co., Ltd....	52,363,125	137,841

At the end of 1936, the relationship between total assets and profit and loss surplus of a random selection of English corporations was as above.

**Earned Surplus.**—Efforts have been made to divide surplus into two parts, one of which is to be considered as “earned surplus” and the other as “capital surplus”—a term that needs apology even when used with the best of intentions. The distinction that this classification attempts to make is easily enough understood. If it were always maintained, it could be justified. But when charges and credits are shuttled back and forth between these two kinds of surplus, the line of distinction disappears. The problems arising from this confusion are beginning to receive serious attention and may eventually be solved. At least one state—Ohio—now provides in its corporation code as follows: “Any excess of assets hereafter arising otherwise than from the earnings of a corporation shall be classified according to its derivation and so shown in separate accounts.”

In spite of the failure in practice to maintain careful distinction between earned and capital surplus, it will aid the reader to understand somewhat better this very confused part of corporation finance if the two are discussed as if they were separate concepts, and as if the distinction were observed in practice. The main sources of earned surplus are essentially two: (1) net profit from operation, remaining at the close of each fiscal period; and (2) profits from a preceding period due to adjustments after the books have been closed for that period. Either or both of these may represent losses rather than gains and may therefore subtract from rather than add to already existing earned surplus. A third source of earned surplus, less common than the two others, is the conversion of reserves no longer needed. When earned surplus has been charged with amounts thought necessary for various reserves, it is proper to credit surplus with amounts remaining in such reserve accounts after their purposes have been served. Nonoperating income is also a part of earned surplus. A good illustration of earned surplus accumulated from earnings is found on the balance sheet of the Ford Motor Co.

In the minds of the laymen, and even of many others who should know better, surplus always implies earned surplus. To the uninitiated, it even suggests a “pile of cash in the back room.” Since the rainbow does not always terminate at that point, this notion has no justification. But long use of the term surplus as an accumulation of past earnings accounts for its common identification with earned surplus. Other uses must take the defensive.

**Earned Surplus Not Earned.**—It should be noted that designating a surplus as “earned” does not always give an accurate description of its origin. For example, in 1936 the “earned surplus” of the North American Aviation, Inc. was \$500,290. This figure was the residual result of subtracting an operating deficit of \$778,528 from an excess of the proceeds from the sale of securities over their stated value, which excess amounted to \$1,278,818. In 1934, the Inland Steel Co. transferred a capital surplus of \$3,000,000 to its earned surplus account. Such examples are sufficiently common to raise

a question of doubt whether even earned surplus results from accumulated earnings undistributed.

**Capital Surplus.**—If capital means what is, to all intents and purposes, permanent investment in the fortunes of a corporation, capital surplus is a misnomer. Capital and investment would always be equivalent terms, and there would be no capital surplus. In financial practices, common sense sometimes sells at a discount because there is so little demand for it. Not only do corporations make frequent use of capital surplus, but they dress it up in such clothes that even its originator would not recognize it at times. It arises from various sources, the most common of which are the following:

1. Paid-in surplus.
2. Donated surplus.
3. Appreciation of assets.
4. Mergers and consolidations.
5. Sale of assets in excess of book value.
6. Reduction in stated capital.

**Paid-in Surplus.**—Paid-in surplus has several sources, including the following:

1. *Sale of Par Stock.*—When par stock is sold at more than its par value, the excess or premium may be credited to paid-in surplus. Companies that have created paid-in surpluses by the sale of par stock at a premium include Westinghouse Electric and Manufacturing Co., Standard Oil Co. (New Jersey), and Standard Oil Co. (Kentucky). The Paramount Pictures, Inc., created its other surplus from the excess of the par value of preferred stock converted into common stock over the par value of the common stock. By giving to \$3 preferred stock, to \$2.50 preferred stock, and to \$2 preferred stock par values of \$1 each and to common stock a par of \$0.10, the American General Corp. created a capital surplus seventy-four times as great as the total book value of its stocks.

2. *Sale of No-par Stock.*—The sale of no-par stock affords the most fruitful source of paid-in surplus. When the Ludlum Steel Co. sold common stock at \$22 per share, it carried \$1 to the capital stock account and \$21 to capital surplus. The Douglas Aircraft Co. sold stock at \$45 per share, apportioning \$10 to the capital stock account and \$35 to capital surplus. The distributable surplus of the Foreign Power Securities Corp., Ltd., is in reality a capital surplus, arising from the sale of common shares. Some no-par stock laws require that a nominal amount of the proceeds be credited to stated value; other laws leave full discretion to the board of directors. The effect is about the same, since stated values determined by law are always low. The New York statutes require \$1 per share or more to be allocated to the capital account or the aggregate of the consideration received for no-par shares. Michigan requires that at least one-half of the consideration for no-par shares shall be allocated to the capital account. Boards of

directors are encouraged to divide the proceeds of the sale of stock between two accounts: capital stock account and paid-in surplus. The division at times assumes absurd proportions. In some cases, less than 1 per cent of the proceeds is credited to the capital stock account.

3. *Stock Assessments*.—By a severe strain upon the imagination, one can see that a corporation which has failed might add to its surplus through assessments of its stockholders, should they agree to pay the assessment. In 1933, the Central Investment Corp. adopted a resolution permitting the company to levy assessments of \$1 each at intervals of not less than 180 days on its \$100-par capital stock. No stockholder was made personally liable for the payment of any such assessment. In reality, the proceeds of such assessments would be used to absorb deficits; in form, they would add to or create a surplus.

4. *Conversion*.—When the Byron Jackson Co. converted its debentures into stock, it created a capital surplus. The Oswego Falls Corp. produced a similar result when it converted preferred stock into common.

5. *Reduction in Par Value*.—The Pacific Coast Co. carried capital surplus in excess of its total asset values. This account resulted from a reduction in the par value of its stock. In addition to this capital surplus, this company had a large capital deficit created by writing down some of its assets, offset by a paid-in surplus created by writing up other assets. It also carried an earned deficit.

6. *Forfeited Subscriptions*.—When a subscriber for stock fails to meet his obligations, he may forfeit to the corporation the payments he has already made on the stock.

7. *Cancellation of Indebtedness*.—By definition, surplus is the difference between stated values of assets and liabilities plus stated capital. Therefore, a reduction in liabilities due to cancellation of indebtedness, or a compromise with creditors, would add to book surplus. The Ohio Leather Co. purchased its debentures at less than face value, thereby creating a capital surplus. This is usually classed with paid-in surplus.

8. *Real Capital Surplus*.—With total assets of approximately \$43,000,000 at the end of 1936, the Cerro De Pasco Copper Corp. carried in its balance sheet capital surplus in excess of \$32,000,000, representing the stockholders' remaining equity in owned properties after capital distributions had been made in earlier years.

Through the use of no-par stock, paid-in surplus, rather than the stock account, may be watered. Not all paid-in surpluses are open to the criticism implied in the preceding sentence. The Monsanto Chemical Co. offered 50,000 shares of \$4.50 no-par cumulative preferred stock, series A, at \$101.50. It proposed to credit \$100 per share to its capital stock account and the remainder to its paid-in surplus account. In effect, this stock appears to be equivalent to \$100-par stock.

**Donated Surplus.**—Closely akin to paid-in surplus is donated surplus. It may have several sources:

1. *Gifts of Assets.*—Bonuses of land or other assets may increase corporate surpluses. Corporate leaders and large stockholders may donate cash or other assets to tide the corporation over periods of stress. These take the form of donated surpluses. In 1936, the Brown Shoe Co., Inc., carried on its balance sheet contributed surplus \$895,031, received in earlier years in the establishment of new factories and transferred from earned surplus for the first time in 1935.

2. *Gifts of Stock.*—When stock is exchanged for property and/or services, a part of it is frequently donated back to the corporation to be sold as treasury stock in order to obtain circulating capital. Whatever the market will pay for it is added to the surplus account. In 1936, the holders of Class B common stock of the Peabody Coal Co. surrendered to the company 991,499 shares, making possible the elimination of a deficit of nearly \$3,000,000 and the creation of a surplus of nearly \$2,000,000, in addition to writing down assets approximately \$7,000,000.

3. *Purchased Stock.*—Stock purchased by the corporation and resold at a profit adds to the surplus in much the same manner as donated stock. Stock purchased at a discount has the same effect. The American Manufacturing Co. created a capital surplus by purchasing its own preferred and common stocks at less than par. The Ohio Leather Co. followed a similar practice in purchasing its preferred stock. In retiring capital stock purchased at a discount, the Indiana and Illinois Coal Corp. increased its capital surplus. The remainder represents revaluation of fixed assets.

**Surplus from Appreciation of Assets.**—Corporations in need of a surplus always have at hand an unfailing Aladdin's lamp in the form of reappraisal of assets. By a stroke of the pen, fixed assets may be increased in value on the books, or intangible values may be added or increased. Corporations that follow this policy have doubtful justification for its use. However, human memories are short, and a surplus created in this manner will soon be indistinguishable from other surpluses not so created. Occasionally, though not often, a corporation is frank enough to indicate the source of such a surplus by labeling it appreciated surplus.

Corporations that used the term or its equivalents—appraisal or revaluation—include The Borg-Warner Corp., Sheridan-Wyoming Coal Co., Coca-Cola Bottling Corp., Lehigh Portland Cement Co., Devonian Oil Co., Chickasha Cotton Oil Co., Hoberg Paper Mills, Inc., Baumann (Ludwig) and Co., Carnegie Metals Co., Gimbel Brothers, Inc., and Security Title Building (under leasehold surplus). Some corporations, such as the Porto-Rican American Tobacco Co., create their capital surplus by revaluation of intangible assets. An interesting case is that of the Hecla Mining Co.,

which carries its mining property as follows: cost, \$952,953; less depletion, \$897,310; plus appreciation, \$1,652,444; balance, \$1,707,467.

The effect of an appreciated surplus is created when a corporation assumes that appreciation of assets offsets depreciation. By failing to provide adequately for depreciation, surplus may be overstated. This case is even worse than the increase of capital surplus through recognition of unrealized appreciation, for failure to provide sufficient depreciation charges increases earned surplus instead of capital surplus.

**Mergers and Consolidations.**—In mergers and consolidations, stock is commonly supposed to be exchanged for assets. If such were the case, existing surpluses would be wiped out, since the stock would reflect the full value of the assets received for it. In practice, however, stock is exchanged for stock, and surpluses are taken over by the new corporation or the merged company. If there are any deficits, they are wiped out in the process. Since mergers and consolidations are frequently accompanied by appraisal of assets upward, resulting surpluses may be larger than the aggregate of those existing before the consolidation or merger.

The capital surplus of the Bates Manufacturing Co. represents the net difference between the amount paid for the property of a merged subsidiary and the value placed upon this property by the parent company. The American Radiator and Standard Sanitary Corp. carried on its balance sheet in 1936, as earned surplus of subsidiaries and affiliated companies at acquisition dates, \$60,671,160. In the meantime, the parent company had accumulated a deficit of \$32,989,905. The capital surplus of the Dominion Rubber Co., Ltd., amounting to more than \$1,500,000 in 1936, is made up of the surpluses of subsidiary companies at the dates of their acquisition.

Reorganizations and recapitalizations of solvent concerns frequently result in increases in surplus by similar processes. Even recapitalizations of failed corporations sometimes result in increased book surpluses through forced reduction in liabilities.

**Sale of Assets in Excess of Book Value.**—Sale of assets at prices that represent increases over book values result in realized appreciation. In case such assets are not to be replaced, the profit may be credited to surplus. However, until the determination is made that replacement will not be necessary, the profit should be credited to a reserve account, since the replacement of the asset may cost more than its book value.

**Reduction in Stated Capital.**—Reduction in stated capital represents stock dividends in reverse. During boom times, corporations cut melons and move surplus up into the capital stock account. When adversity strikes them, they reverse their gears and move stated capital down to the surplus account. During the years 1931 and 1932, many American corporations wiped out deficits and created surpluses by this means. Perhaps the corporation has suffered long periods of adverse earnings or decline in asset values from

nate a deficit. The Western Electric Co., Inc., transferred \$37,500,000 from surplus to its capital stock account. Four years later, it transferred the same amount from its capital stock account to surplus.

**Uses of Earned Surplus.**—In spite of the discouraging conclusions to be drawn from the above analysis, there are specific reasons for the accumulation of earned surplus. Where it is honestly designated as such, the managers of the corporation probably have more or less well-defined purposes in mind in building it up. Among them are the following:

1. Earned surplus is a source of capital, particularly among young corporations without strong credit standing in the security markets. Until their earnings experience gives them a satisfactory credit rating, they may be dependent upon their earnings for their growth. Even established enterprises find accumulated earnings useful for the purpose of expansion when market conditions do not favor the use of other sources of capital which are normally available. Many corporations pursue a policy of plowing back a part of their earnings, regardless of the condition of the money market and their ability to dispose of new securities. Some even make a fetish of plowing back a certain proportion of earnings each year.

2. Accumulated and undistributed earnings are used to absorb losses of various kinds. If the operations of a lean year result in a loss instead of a profit, the surplus absorbs it. Most businesses must continue to operate through lean years as well as profitable ones, even though their managements know that they cannot make operating expenses when business is dull. They expect to offset losses with later profits. Meantime, they need accumulated profits to absorb losses as they occur. Losses resulting from the use of inaccurate accounting methods which, for example, credit too little to valuation reserves, may be offset by the presence of an earned surplus. In like manner, an earned surplus is a convenient sponge to absorb the water in inflated assets.

3. The use of earned surplus as a source of dividends will be discussed in a subsequent chapter.

In considering these uses of earned surplus, we must keep in mind that they are limited by the past practices of the corporation. For example, suppose that, over the years, the management has used its earned surplus for the purpose of expansion as rapidly as it accumulated. Suppose that, in a year in which the corporation just breaks even, it wishes to expand further. Although it has a large book surplus, it cannot be used for further expansion. Losses, on the other hand, can be charged against surplus so long as there is any credit remaining in this account. Thereafter, further losses would result in building up a deficit.

**Surplus Policies.**—Some corporations use their surplus accounts as window dressing. As a matter of fact, no management likes to see its balance sheet record a deficit or even a small surplus. That is why so many adjust-



ments are commonly made to eliminate deficits and to add to surpluses whenever these accounts show unsatisfactory balances. Tradition helps to determine the nature of some surplus accounts. For example, a bank surplus is traditionally more conservatively built than that of an industrial corporation. The bank management is not only careful to make sure that its surplus is real, but it often charges down its real estate to less than its true value, thus creating an unnecessary charge against the surplus. In contrast, a public utility whose rates for service are determined by the value of its capital used and useful is frequently inclined to use a large surplus as evidence of great investment even though the surplus arose from revaluation of assets. As stated earlier in this chapter, the source of the surplus is frequently indistinguishable in the balance sheet.

**Uses for Capital Surplus.**—Earned surplus may be absorbed by capital surplus. As such, it should be considered a part of the permanent investment of the corporation. The uses for capital surplus are various. In industrial corporations, it is used for expansion. In insurance companies, it protects investments against declines in values. The use is determined in large part by the source of capital surplus. For instance, donated stock is frequently resold, at whatever price the market will pay, to provide funds for circulating capital. Assets are written up or the capital stock account written down to absorb deficits.

Appreciation surplus sometimes absorbs depreciation charges. Companies that follow this practice include the Chickasha Cotton Oil Co., the Hoberg Paper Mills, Inc., and the Carnegie Metals Co. Capital surplus is used also to absorb operating deficits. The Kinney Co. reduced its capital surplus from \$2,486,682 to \$2,048,426, thereby absorbing an operating deficit of \$438,256.

#### SURPLUS APPROPRIATIONS

**Proprietorship vs. Valuation Reserves.**—Valuation reserves are used to restore the integrity of investment when assets have suffered loss in value or liabilities have not been met. Some accountants recommend the use of the term "allowance" instead of "reserve" in such cases. Some distinguish liability reserves from valuation reserves, using the latter to describe asset rehabilitation only. Common usage, however, has not yet sanctioned these suggestions. There exists unfortunate confusion at this point.

Proprietorship reserves represent quite a different concept. After all valuation reserves have been properly taken care of, the value of the proprietorship of the business is measured by the sum of the capital stock account and the surplus account. In other words, so long as the business continues to be a going concern, the surplus is considered to belong to the proprietors. Nevertheless, for the reasons described below, it may be desirable to earmark parts of this surplus for specific purposes. The

parts earmarked for purposes other than valuation reserves are known as "proprietorship reserves."

**The Blanket Surplus.**—The concept of surplus is viewed from two angles: One looks upon this account as measuring the equity of the owners of the business over and above the capital stock account, which is supposed to represent investment. This equity is considered as a sort of blanket, covering many corporate purposes. Such a concept is vague and indefinite. Its proponents would have difficulty in analyzing it into its parts and in allocating to various purposes the amounts belonging thereto. In general, they recognize that such a surplus is not merely a source of dividends but has various other functions as well.

The other concept of surplus is that it is the residual proprietorship equity remaining after all possible reserves have been provided for. To the advocates of this theory, boards of directors are obligated to set aside appropriations, not only to rehabilitate assets whose value has suffered loss and to provide for liabilities not yet liquidated, but to anticipate future financial needs of the corporation and to provide for them as far as possible by specific appropriations. The balance remaining after such appropriations is surplus, not needed by the corporation and therefore available for distribution to the stockholders in the form of dividends.

The all-purpose surplus is deceptive. To the stockholders interested primarily in dividends, the surplus is the measure of the amount that may be distributed to them. Even boards of directors are often misled into forgetting other purposes and dividing all surplus among the stockholders.

**Liberal Appropriations Recommended.**—It is recognized that the most important consideration is the accumulation of a surplus. Appropriations therefrom are matters of accounting mechanics. But since the component parts of surplus are apt to be inflated, it is recommended that liberal appropriations be made to serve the needs of the corporation. The balance, free surplus, may be distributed as dividends. The appropriations serve two purposes: (1) they prevent the dissipation of that part of the surplus in the form of dividends; and (2) they call attention of the officers and directors to the needs for which the appropriations are made.

**Purposes of Surplus Appropriations.**—In general, appropriations from surplus are made for four groups of purposes, as follows:

1. To provide for increases in capital.
2. To anticipate, and thus enable the corporation to meet, emergencies.
3. To equalize dividend payments.
4. To supplement valuation reserves.

**Increases in Capital.**—When boards of directors decide definitely upon additions and betterments to be provided for out of surplus, they should make specific appropriation therefor under some such title as reserve for plant additions. This action calls attention to their intent and avoids

dissipation of the surplus. Should they decide to increase circulating capital instead, they can indicate their intentions in a reserve for circulating capital. Until 1936, the American Snuff Co. carried a surplus reserve for working capital. In 1936, this was merged with its undivided profits. Some corporations in regulated industries, such as railroads and public utilities, sometimes are required to make investments of capital that add little to operating revenue. They are usually called unproductive improvements.

Closely akin to reserves for increases in capital investment are those whose purpose is to change the form of such investment. Bond sinking-fund reserves are of this nature. They anticipate and assist in making provisions for the retirement of the bonds. In the absence of sinking-fund requirements, reserves may be made to retire preferred stocks and bonds which the corporation has made no agreement to redeem but which may be called or even purchased in the open market. Reserves may be employed to anticipate the redemption of such securities in order to reduce fixed charges and preferred-stock dividends, to strengthen the credit standing of the corporation, and possibly to provide for new financing.

**Meeting Emergencies.**—Various types of contingency reserves are sometimes used. The contingency may be specified in the name given to the reserve, such as a reserve for undetermined taxes, or it may be included in a blanket reserve carrying the general title of contingency reserve. All sorts of contingencies may require the attention of the corporation. Changes in consumer demand or in methods of production may result in hardship for the corporation that has no cushion of contingency reserve to absorb the shocks of changing into more profitable operations.

Financial institutions, dependent for solvency and success upon maintaining the values of their investments, may suffer greatly from market declines. Contingency reserves, under whatever title, would prove exceedingly useful to such institutions. Investment trusts are learning a lesson from past stock-market collapses and are setting up reserves to anticipate declines in security prices. Insurance companies face a similar problem.

The business cycle is a well-recognized phenomenon, the comprehension of which seems beyond even the ablest of business leaders. Most businessmen sense the possibilities of profit fluctuations. Few have undertaken to set up specific contingency reserves to provide for such changes. The timing and extent of changes baffle us and discourage us from attempting specifically to account in advance for them. In most corporations, the desire for a large surplus is the somewhat inarticulate answer of the businessman to the need for contingency reserves. Difficulties with such an answer arise when least expected. When profits are small, attention is centered upon business uncertainties. When prosperity arrives, adversity is forgotten, and large dividends may dissipate the all-purpose surplus.

Not only is surplus expected to bear the burdens of future emergencies, but it is charged with the expense of losses overlooked in the past. When they are discovered, the surplus account is expected to absorb them.

Some contingencies should be anticipated as a part of the corporation's operating program and should be charged to revenue. These are different in nature from those to be provided for by appropriations of surplus.

**Dividend Equalization.**—The advantages of regular dividend payments will be discussed in the next chapter. There is always more or less fluctuation in net earnings, sometimes of very great proportions. In spite of this, distributions to stockholders can be more or less stabilized through the use of dividend reserves. A part of the large earnings of prosperous years can be set aside for payment to the stockholders during the lean years. It takes courage to deny stockholders large distributions when earnings are high, and it takes more courage to pay out dividends when the corporation is operating at a loss and facing an uncertain or disheartening future. On the whole, however, times of depression show greater decreases in earnings than in dividends. In times of prosperity, earnings increase more rapidly than dividends, indicating that as a rule corporations make some attempt to equalize dividends.

The American Car and Foundry Co. carries a reserve for dividends on common stock to be paid when and as declared and a reserve for improving working conditions of employees. These reserves have remained constant for several years, the former at approximately \$3,000,000 and the latter at approximately \$62,000.

**Supplementing Valuation Reserves.**—However carefully declines in asset values may be anticipated, they are always estimates based upon someone's forecast of the future. If such forecast should prove too optimistic, it may be necessary to supplement valuation reserves by charges to surplus. Obsolescence may be more rapid than anticipated, owing to inventions. General economic conditions may prevent the collection of debts thought collectible. To the extent that revenue is charged too little for the purpose of carrying valuation reserves, surplus must be expected to make up the deficiency. Paramount Pictures, Inc., in 1934 established a reserve for anticipated losses. Results of operations in subsequent periods demonstrated the wisdom of this action.

**Special Reserves.**—A few perplexing questions vex the accountant who attempts to draw sharp distinctions between valuation and surplus reserves. Some are not easy to classify. For example, if a corporation receives pre-paid interest upon an investment, the earned part belongs to income, but the unearned portion does not. With the passing of time, all interest paid should be reflected in earned surplus. Meantime, it may be necessary to set up special reserves of the nature of proprietorship reserves to account for the unearned portion.

**Paid-in Surplus and Reserves.**—A paid-in surplus may be a proprietorship reserve in its fullest sense. It belongs to the owners of the enterprise. If it represents premium on stock paid in by purchasers of stock in a bank or an insurance company, for instance, it has a very definite purpose to serve. On the other hand, paid-in surpluses which record much of the proceeds from the sale of no-par stock could hardly classify under this qualification.

**Hiding the Surplus.**—Since most people, including stockholders and tax assessors, make no distinction among kinds of surplus and often consider any surplus as a sign of affluence, corporate managers at times play “hide the surplus.” Only insiders are permitted to play the game. Indeed, the object of the game is to keep others from knowing that a surplus exists. Surplus is hidden by various methods, a part of which result in undervaluation of assets and the others in overstatement of liabilities. The most common are as follows:

1. Undervaluation of assets by:
  - a. Charging additions or betterments to revenue.
  - b. Removing assets from the books by a charge against surplus.
  - c. Excess depreciation charges or arbitrary reductions in asset values not warranted by conditions.
2. Overstatement of liabilities by:
  - a. Arbitrary excess charges to various accounts.
  - b. Use of fictitious liabilities.

**Manufacturing Surpluses.**—The converse of hiding the surplus is the creation of surplus items by means at least out of the ordinary. Such methods include the following:

1. Understatement of liabilities by:
  - a. Omission of liabilities, actual or contingent.
  - b. Failure to follow adequate depreciation policies.
  - c. Disregard of tax burdens.
2. Overstatement of assets by:
  - a. Accounting for profits not realized.
  - b. Failure to account for losses on assets lost or otherwise disposed of.
  - c. Failure to account for known shrinkages in value.
  - d. Failure to write down or provide against bad and doubtful accounts.
  - e. Failure to amortize prepaid and deferred items carried as assets.

**Reasons for Hidden Reserves.**—As already indicated, surplus is hidden from somebody. This somebody may be any of the following:

1. The managers of the corporation themselves, wishing to appear conservative, so that their actions may carry no taint of wild speculation, sometimes dictate the hiding of surplus in such manner as to remove the temptation of unduly large dividends or overexpansion.
2. Stockholders are kept in ignorance of the true state of accumulated past earnings for one of two reasons: either to prevent them from demanding

distribution of a surplus that the corporate managers think should be conserved to carry the corporation over lean years; or to induce them to sell their stock to the corporate managers or their friends at less than its true value.

3. Creditors are kept in a more "reasonable" frame of mind if they can be influenced to believe that the corporation is not in a position to liquidate its debts immediately.

4. Competitors, actual or potential, find less reason to strive for a share of earnings of the existence of which they are ignorant.

5. Tax assessors and legislators may temper their actions to the corporation shorn of the appearance of affluence. If hidden reserves should be large enough to create the appearance of a deficit, government officials may even feel compassionate toward the corporation.

Hidden surpluses constitute proprietorship reserves. When a bank writes down its building to a nominal amount, or when actual good will is carried on the books at a similar amount, values are understated. Since the amount of the hidden surplus is not shown on the balance sheet, it is not available for dividends. Showing of liabilities that do not exist has a similar effect. While hidden surpluses, secret reserves, or whatever name they are given, do not serve specific purposes expected of most proprietorship reserves, they qualify as such reserves from another point of view. If a reserve may be classed as something to fall back upon in time of need, then secret reserves are in this class. A five-million-dollar bank building carried on the books at one dollar can easily become again a five-million-dollar asset when needed.

**Effectiveness of Surplus Appropriations.**—The mere accumulation of a surplus should guarantee conservatism in its use. The misinterpretation placed upon the term by both stockholders and directors justifies its separation into the various reserves discussed herein. Two accomplishments of such earmarking are (1) removal of the surplus from dividend temptation, and (2) the concentration of attention upon the purposes named in the titles of the surplus reserves. Beyond this, too much should not be expected of surplus reserves. Reserves are most effective when combined with funds whose administration is in the hands of trustees not interested in the management of the corporation. If the reserves represent investment in plant and equipment, it may not be possible to convert them into cash when needed. Even here, such investment should strengthen the credit standing of the corporation and facilitate borrowing when cash is needed. If the reserves are not set aside, the surplus may be dissipated in dividends, and not even the assets will be available as a basis for borrowing.

**Reserve vs. Fund.**—Surplus reserves must be carefully distinguished from funds. The former never assure the payment of obligations. Only a fund of cash, or its equivalent, set aside from other assets and earmarked for a purpose, can accomplish that. Funds are assets and are carried on the

balance sheet as such. Reserves are usually appropriations of surplus and are carried on the equities side of the balance sheet. They may have no relation to specific assets, or they may be offset by reserve funds set aside to fulfill the purpose indicated by the reserve account.

**Control over Surplus Appropriations.**—Boards of directors usually have full authority to set up such reserves as they see fit and to make such credits thereto as suit their fancy. This invites considerable shifting about of credits from surplus to reserves and back again with or without justifiable reason. In a few states, directors are required by law to distribute all annual profits unless otherwise authorized by action of the stockholders. Compulsory distribution of all profits annually might not serve best the interests of the corporation. Therefore, such laws are usually nullified by action of the stockholders. The latter, however, by either charter or by-law provision, occasionally set limits to the discretion that may be exercised by boards of directors.

**Final Disposition of Surplus Appropriations.**—In a sense, an appropriation of surplus might be called a revolving surplus. When the account is set up, surplus is charged, and the reserve is credited. Additions to the reserve follow the same procedure. After the purpose for which the reserve was set up has been fully served, the reserve is returned to the surplus account by a charge to the reserve account and a credit to surplus.

With valuation reserves, on the other hand, only remainders in the reserve account, after the reserve purposes have been served, ever find their way to the surplus account. If the valuation reserve has been accurately set up and utilized, there will be neither a credit nor a debit to the surplus account when the reserve account is closed out.

### QUESTIONS AND SUGGESTIONS

1. What is the origin of the surplus account?
2. In what way might surplus be called an adjustment account?
3. Why is surplus designated as a mystery of mysteries?
4. What advantages might flow from using qualifying adjectives in describing surplus?
5. How is it possible for a corporation to have a deficit greater than its total assets?
6. How does English practice in dealing with surplus differ from American?
7. What is earned surplus? Is it always earned? Explain.
8. What is capital surplus? What are its sources? What are the weaknesses of its use?
9. Can you have an addition to capital surplus through appreciation, without writing up assets? Explain.
10. Show how surplus is sometimes increased in mergers and consolidations.
11. What are the uses of earned surplus?
12. In what manner may a surplus account become window dressing?
13. What are the uses of capital surplus?
14. Differentiate between proprietorship and valuation reserves. Which is related to surplus? How?

15. What is a blanket surplus? Why is it so called?
16. What is the alternative to a blanket surplus? Why are liberal appropriations recommended?
17. What specific reserves are recommended?
18. What is meant by hiding the surplus? How is it accomplished? How can surplus be manufactured?
19. How effective are surplus appropriations? What is finally done with them?

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#### SUBJECTS FOR INVESTIGATION

1. From current issues of the *Commercial and Financial Chronicle* or from a recent manual, find two corporations with capital surplus recorded on their balance sheets. What is the significance of this item in each case?
2. Find a corporation which has created or added to a surplus account by reducing its stated capital. See if you can determine why this was done.
3. Select at random five industrial corporation balance sheets. How many surplus reserves can you identify from these reports?



## CHAPTER XXXII

### DIVIDEND POLICIES

**Evolution.**—The concept of dividends and dividend policies has had an interesting evolution. In the early English trading companies, each venture was a separate business enterprise. At its conclusion, the entire assets, including capital contributions and profits, if any, were disposed of and the proceeds were divided among the contributors. New ventures were organized by those who wished to participate in them. There was no need for a distinction between profits and capital contributions. Gradually the same group continued to operate in successive ventures until it became customary to leave in the business more or less fixed amounts of capital. Liquidation of fixed assets was not always practicable since considerable loss might be suffered in disposing of them. This made necessary some distinction between distributable profits and necessary capital. At the outset, the distinction was not always too sharply drawn. This differs but little from the practices of sole proprietorships and some partnerships in the period preceding the time when accounting for income-tax purposes became important. The consumption needs of the proprietors and the partners dictated the amounts to be withdrawn from the business, regardless of whether the withdrawals represented earnings or capital contributions. There was no compelling need to designate profits as such or to be concerned about their distribution.

With the organization of the more impersonal corporation, however, there arose the necessity for distinguishing profits from capital contributions. Where the investor is divorced from control over his property by placing it in the hands of corporate managements, presumably he expects for the use of his capital a profit return. Indeed, in the minds of a great many people, profits and dividends are almost synonymous terms. Those whose experience with business finance is quite limited are prone to assume that when a corporation earns profits, its stockholders will benefit by the receipt of dividends. Except for those who buy listed stocks in the hope of making a profit from an increase in price, most stockholders are induced to make their commitments on the promise of a satisfactory yield on their capital. It will be worth while to keep this in mind as we proceed with the discussion of dividend policies and practices.

**Discretion of Directors.**—Almost without exception, dividend policies are determined by boards of directors. Officers have no voice on this question

except as they are able to influence or to dominate boards of directors. As a matter of fact, they are usually consulted but the decision rests with the directors. In both early English and early American corporations, it was not uncommon for dividend policies to be determined by the stockholders. This is no longer the case. Stockholders as such have no voice on this question, in the absence of fraud or mismanagement. Laws governing the declaration of dividends seldom attempt to limit the discretion of directors, except to hold them to good faith and except as noted below. Courts usually uphold the right of directors to decide the timing, kinds, and amount of dividends, whenever these subjects are brought up for adjudication. It is only infrequently that courts are asked to pass upon dividend policies.

**Legal Restrictions.**—In addition to the adherence to good faith in establishing dividend policies, boards of directors are subject to a series of legal restrictions which are intended to maintain the capital of the corporation. In the adoption of the principle of limited liability for stockholders, legislative bodies have sought to set up a concept of a "capital fund" as a minimum safeguard for the protection of creditors. Throughout the nineteenth century, there appears to have been a definite intent to prevent the withdrawal of a corporation's capital, in the form of dividends or otherwise, if its results might be seriously to weaken the position of the creditors. In putting this principle into effect, legislatures placed the following restrictions upon the discretion of boards of directors in determining dividend policies:

1. Dividends may be declared legally only from unappropriated surplus. In case the corporation shows a deficit, this must be absorbed before dividends can be declared. However, there are various ways of absorbing deficits, as has already been discussed in a previous chapter.

Also, laws may be ignored or evaded. At the end of 1936, the Indian Refining Co., with total assets of less than \$10,000,000, had outstanding taxes and accruals in excess of \$1,000,000, advances from its parent corporation of approximately \$7,500,000, common stock with a book value of \$12,702,070, and an operating deficit of \$15,405,136. In spite of this condition, on Dec. 4, 1936, it declared on its common stock a dividend in 5-year notes, amounting to \$1 per share.

2. In most of the state corporation codes, words and phrases are used which are apparently intended to limit cash dividends, at least, to accumulated profits. Wisconsin permits the distribution even of cash dividends from a surplus created by appreciation of assets provided that "the total amount of such dividend shall not exceed the actual cash value of the assets owned by the corporation in excess of its total liabilities, including its capital stock." Ohio permits stock dividends but prohibits cash dividends, from appreciated surplus. The various state codes leave the meaning of the term "profit" to the interpretation of the courts.

3. The same condition can be stated in another way when we say that the law frowns upon dividend declarations that impair the capital of the corporation, particularly when such impairment results in, or is accompanied by, insolvency.

4. Several important questions affecting dividends have been given little consideration by statutes, and even the few court decisions are conflicting and inconclusive. For example, the right of corporations to declare dividends from stock premiums is still an unsettled legal question.<sup>1</sup> From the standpoint of economic policy, it would appear that, whatever the legal rights involved, dividends should not be declared from such a source without giving the stockholders full information on the subject. In like manner, the declaration of dividends from a surplus created by writing up assets does not represent conservative business practice, whatever the law may permit. To what extent depreciation and depletion should be accounted for before dividends are declared legally is another unsettled question. Courts and statutes are not too lucid in dealing with such questions as accruals of income and expense before dividend declarations.

**Unlawful Dividends.**—When boards of directors declare dividends unlawfully, their action must first be discovered by some party at interest. The discovery must be brought to the attention of the courts and redress asked. Allegations must be proved and the culpability of the directors established before restoration can be demanded. If the directors have acted fraudulently or if they have grossly neglected their trust, they can be held liable to the corporation in amounts that vary in different jurisdictions.

It has been stated that a good general rule for corporation directors to follow is: "As against the dissent of stockholders or creditors, a dividend can lawfully be made only out of profits. The payment of it must leave the capital stock of the company intact and unimpaired, or the dividend itself, if objected to, will be held illegal."<sup>2</sup>

**English Law.**—In English procedure, earnings are kept separate from investment, in theory at least. Any or all earnings may be distributed in the form of dividends irrespective of the existence of a capital deficit. English practice is consistent in placing restrictions upon dividend declarations except from earnings. It is based upon the conception that capital can be used only for the purposes of the business to which it is contributed. As a consequence, to reduce this capital either by dividend declarations or by the purchase by the corporation of its own shares would be a violation of the above stated principle.

<sup>1</sup>Briggs, L. L., Dividends from Stock Premiums, *Journal of Accountancy*, May, 1932, pp. 346-353.

<sup>2</sup>Mason, Perry, Profits and Surplus Available for Dividends, *Accounting Review*, March, 1932, pp. 61-66.

**Shift of Emphasis.**—With the introduction of no-par stock and particularly with the use of capital surpluses of various kinds has come a change in emphasis upon the legal protection given the creditors of modern corporations. It is possible to put into the "capital" account only a fraction of the amount invested by the stockholders. While most of the statutes retain the fetish of creditor protection, they wink at practices that may leave little actual protection. Some statutes go so far as to permit dividend payments even though there is a capital impairment at the time. A recent amendment to the corporation code of the state of Delaware permits corporations to declare dividends from accumulated surplus or from the earnings of the current or the preceding year. With alternate years of profit and loss, the net result might be the absorption of the capital, to the disadvantage of creditors, while the stockholders were enjoying their annual dividends.

As a consequence of recent legislation and of the practices that are outgrowths of it, there appears to be, in the minds of legislators, a feeling that corporations should be looked upon as going concerns and not as possible candidates for liquidation. This means that, more than ever, the questions raised in the determination of dividend policies have a business rather than a legal background. Weakening of legal restrictions has resulted in placing greater discretion in the hands of boards of directors. How well they have discharged this responsibility is recorded in recent and in current dividend history.

**Prevailing Theories.**—Expediency rather than basic convictions frequently determines policies of corporate managements. Nevertheless, three types of theories may be distinguished in the consideration of dividend policies: (1) Some managements follow a practice of plowing back earnings into the business without apparent limit and without apparent adequate consideration of the rights of security holders to determine the disposition of the earnings from their investments. (2) At the other extreme, there appears occasionally a corporation policy that seems to favor complete distribution of all earnings, leaving their final disposition to the holders of the corporate securities. (3) Between these two extremes is the practice of distributing a part and plowing back a part of the earnings. Even here the practice is frequently difficult to justify on logical grounds. "A dollar back for every dollar distributed" may be a catchy slogan, but what justifies it?

**Contingency Theory of Dividend Distribution.**—It has been proposed that a better basis for determining dividends is the use of what may well be termed the "contingency theory." Under this theory, dividend policies would be determined by the corporation's need for funds to meet contingencies, such as: those concealed in accounting statements; those certain in occurrence but uncertain in time, *e.g.*, destruction of or damage to property; those uncertain in occurrence and time, *e.g.*, new or heavier taxes, changing

social and political conditions, unforeseen capital losses due to international complications; those resulting from the effects of business cycles; etc.<sup>1</sup> To the extent that contingencies can be translated into probabilities and that these in turn can be measured and labeled with dollar values, reserves are expected to be established against them. All this and more should take place before any consideration is given to dividend distributions.

As a matter of fact, most boards of directors take into consideration a variety of factors in determining their dividend policies and changes therein. Among the more important are the following:

1. Current financial condition.
2. Needs for additional capital.
3. Extent of stock distribution.
4. Kind of business.
5. Age of corporation.
6. Stage of the business cycle.
7. Changes in public policy.
8. Taxes.
9. Contingencies.

**Current Financial Condition.**—At any particular time, the cash position of the corporation may be the determining factor in dividend declarations, particularly of cash dividends. A corporation that gives any consideration at all to dividends probably has an ample book surplus. Even the strongest companies, with tremendous surpluses on their books, trim dividend declarations when cash gets low. At such times, cash is conserved to protect the corporation against possible future needs. In 1931 the U.S. Steel Corp. suspended dividend payments with accumulated net earnings in excess of \$1,000,000,000; with current assets of \$500,000,000 including \$150,000,000 in cash and marketable securities; and with net current assets in excess of \$400,000,000. In justification of the suspension of dividends by the board of directors, the president of the corporation pointed to the need for conserving cash resources in order to prepare the corporation to face whatever emergency the uncertain future might bring forth.

**Needs for Additional Capital.**—When a corporation depends upon its own resources for growth, it must conserve its cash when expansion is being planned. The Certainteed Products Corp. passed its regular quarterly dividend on its preferred stock in 1937 and gave as the reason conservation of its cash for the demands of anticipated business expansion. Should earnings be insufficient to meet the demands of both dividends and expansion, the former may give way to the latter. Other corporations, with strong credit ratings, may distribute their earnings and depend upon the sale of securities for expansion. Since expansion usually takes place during

<sup>1</sup> Sage, G. H., *Dividend Policy and Business Contingencies*, *Harvard Business Review*, Winter, 1937, pp. 245-252.

periods of prosperity, security markets easily absorb new offerings of well-known corporations with established credit. Dividend distributions are used at times to assist new security issues.

Some corporations cannot depend upon earnings as a source of new capital. Corporations like railroads and hydroelectric plants, having a slow capital turnover, would not be able to accumulate earnings fast enough for extensive capital additions, even though they paid no dividends. In such businesses, capital expenditures may be out of proportion to immediate expansion needs. For instance, if a railroad already operating a single-track line to capacity wished to add 10 per cent to its capacity, it might need to double-track its line, possibly increasing the investment more than 100 per cent.

**Extent of Stock Distribution.**—A small number of stockholders, closely associated in a close corporation, might willingly acquiesce in a suspension of dividends. A corporation with stockholders widely distributed would have greater difficulty in securing such ready acceptance of a reduced-income policy. A reduction in dividends under such circumstances can be made, but not ordinarily with the hearty cooperation of the stockholders.

As a general rule, stockholders of a corporation whose shares are widely distributed have less knowledge of its affairs than do stockholders in a close corporation. Their relationship to it and to each other is more impersonal. They prefer to receive regular dividends. Their preferences cannot always be observed, nor is there anything that such stockholders can do effectively about changes in dividend policies.

**Kind of Business.**—The nature of the business conducted by a corporation will have an influence upon its dividend policy. A speculative enterprise with highly fluctuating earnings will ordinarily follow a different dividend policy from a business with steady earnings. Generally speaking, concerns that deal in consumer necessities suffer less from fluctuating earnings than those which deal in luxuries or in capital goods. Capital goods enjoy the greatest demand when industry is prosperous. The earnings of corporations producing such goods frequently are recorded in red ink during periods of depression.

**Age of Corporation.**—Closely related to the nature of the business is the age of the corporation that conducts it. A young business may need much of its earnings for growth. Then, too, time is required to determine its expected earnings and to know what to depend upon from year to year. An older corporation, having attained its major growth and with a longer earning experience, may more safely distribute its earnings. Age alone is not, however, a determining factor. The Erie R.R. Co., more than a century old, has paid but few dividends on its common stock. On its second preferred stock it paid no dividends from 1907 to 1929 and none after 1930. On its first preferred it paid no dividends from 1907 to 1929 and none after

1930. The company experienced its latest reorganization in 1941. In spite of such examples as this, it is still true that stability of earnings, together with maturity of the industry—both of which are influenced by the age of the corporation—goes far toward determining dividend policies.

**Stage of the Business Cycle.**—The effects of the business cycle influence dividend policies in various ways. Earnings vary from stage to stage, demands for capital investment change, and money markets become tight or easy. Cash positions safe at one time become unsafe at another. Corporation managers, like everyone else, tend to become too optimistic during periods of prosperity and too pessimistic during periods of depression. Where dividends are used to influence the sale of stock or conversion of bonds, they may be expected to increase at a time when their influence will be most effective in producing the desired results.

**Changes in Public Policy.**—Regulatory and restrictive legislation may adversely influence the dividend policies of corporations affected. Easing of such regulations tend to produce the opposite effects. When the Pennsylvania legislature enacted a chain-store tax law, the American Stores Co. cut its quarterly dividend in half. The imposition of priorities rules against corporations not engaged in essential war production during the Second World War reduced the earnings and caused the passing of dividends of many corporations. At the same time, the increase in business that the railroads enjoyed, when restrictions were placed by the government upon competitive modes of transportation, helped some railroad companies to resume the payment of dividends after years of no payments to stockholders.

**Taxes.**—The Federal undistributed-profits tax of 1936 resulted, among other things, in changes in dividend policies of corporations. Both the amount and the kinds of dividends declared were influenced very directly so long as this law was in effect. More recently, tax policies adopted to raise the revenue to pay the cost of conducting the Second World War have profoundly affected dividend policies of a great many corporations. Even those which operated at capacity to fulfill war orders and which set new records of gross revenue and even of net income before taxes found that taxes took the lion's share of their earnings. It seems likely that the tax burden upon business corporations for the indefinite future will be a determining factor in fixing dividend policies.

**Contingencies.**—A wide variety of factors that may affect different corporations in different ways or at different times help to determine dividend policies. Not all these can be anticipated far in advance. Shortages in raw materials, brought about as the result of the Second World War; changes in hours and wages resulting from Federal legislation; introduction of new models; introduction of installment selling; changes in the price and sources of supply of raw materials; even changes in weather, resulting in increases

or decreases in a demand for the corporation's product; any of these and many more contingencies may affect dividend policies.

**Judgment of Directors.**—The preceding analysis suggests that dividend policies result from a nice balancing of factors that boards of directors weigh very carefully before they arrive at their decisions. As a matter of fact, while these considerations are taken into account, directors more often rely upon their "judgment," which is based upon their past experiences but which is not subject to analytical measurement. In American experience, at least, there is a general feeling among corporate managements, shared probably by most stockholders, that dividends should not distribute all the earnings of the corporation. Also, in spite of improvements in accounting procedures, there is a general distrust of calculations that seem to carry suggestions of too great accuracy and finality. As an offset to possible errors and omissions, most directors are inclined to "play safe" in the distribution of earnings.

Until recently, the directors of most corporations have assumed that few stockholders would question their judgment in arriving at dividend policies. As a consequence, little has been done to inform the owners of the corporation as to why dividends are kept low in the face of increased earnings, for example. It is still the general policy for boards of directors not to take stockholders into their confidence on such questions. In some quarters, however, there is a growing feeling that those who own the corporation's stock are entitled to know the reasons for some of the basic policies of the corporation. As a result, pamphlets and letters are being sent out by the management to account for such questions as changes in dividend policies. This increase in publicity among corporations whose stock is widely distributed is a healthy change from earlier programs of secrecy. While only a start has been made in the direction of more comprehensive reports, perhaps the advantages of the change will soon become sufficiently apparent to encourage its extension.

As is to be expected in institutions subject to human control, there is a wide difference in dividend policies among different corporations. This difference is evident both in the determination of dividend policies and in the attitude of corporate managements toward their responsibilities to their stockholders. An excellent contrast is found in the dividend policies of the Radio Corporation of America and the Diamond Match Co. The former company was organized in 1919. Although it earned nearly \$50,000,000 during the first decade of its life and although its stock rose to over \$400 per share in the latter 1920's, it paid no dividends until 1937. Meantime it must be admitted that it was expanding rapidly in the whole field of communications, including the manufacture of radios, broadcasting, talking machines, and even motion pictures. The Diamond Match Co., by contrast, paid dividends quite regularly even in years when its distributions exceeded



its earnings. It should be pointed out that the earnings of this company have been very regular and that its opportunities for expansion in recent years have not been so great as those of some other corporations.

**Regularity of Dividends.**—Regularity of dividends is of most significance to those who purchase stock for investment. Speculation and speculators thrive on changes, whereas the essence of investment is stability, both in amount and in regularity of payments. The confidence of investors in the stock of a corporation rests upon its regular dividend policy. This is particularly true of preferred stockholders, whose preference in dividend declarations usually sets the upper limit of their share in corporate profits. The urge for regularity in preferred-stock dividends is strong.

Corporations that have need for a loyal group of preferred stockholders try to maintain regular dividends thereon. With the best of intentions, however, economic conditions may prevent such a program. For example, after 18 years of uninterrupted distribution of annual dividends on its preferred stock at the rate of \$6 per share, American Ice Co. reduced this rate to a \$2 annual basis in 1935. Total income of the corporation was well maintained during the period from 1925 to 1931, though dropping somewhat in the latter year. From then on, the effects of artificial refrigeration began to take their toll. The year 1936 showed total income less than 14 per cent as large as in 1930. Earnings per share of \$22.63 on preferred stock in 1930 were reduced to \$1.12 in 1936. Interest and preferred dividends were earned three times in 1931 and only 0.35 time in 1936.

Common stock may be dealt with somewhat differently from preferred stock. The common stock of a new corporation is expected to be speculative. Its holders have no right to expect the early and continuous receipt of large dividends, albeit they may have been given such promises when they bought the stock. A corporation not interested in the manipulations of the prices of its securities might well forgo all common-stock dividends until it has built up a strong cash position and has accumulated a sizable earned surplus. It may then, future prospects permitting, establish a dividend rate that it can have some hope of maintaining.

The Pennsylvania R.R. Co. has paid cash dividends, varying from 1 to 10 per cent, every year since 1847. In addition, it paid stock dividends as follows: 1864—30 per cent; 1867—5 per cent; and 1868—5 per cent. Scrip dividends, payable in stock or cash and ranging from 2 to 5 per cent, were paid in 1873, 1880, 1882, 1883, 1884, 1891, and 1893. The Illinois Central R.R. Co. paid dividends on its common stock without interruption from 1860 to 1931 at rates varying from 4 to 10 per cent. From 1905 to 1930, the rate was 7 per cent per year except as follows: 1913—6 per cent; 1914—5 per cent; 1915—5 per cent; 1916—6½ per cent. In 1931, 3¾ per cent was paid. From 1931, no dividends were paid until the years of the Second World War.

A regular dividend is not an unmixed blessing, so far as the corporation is concerned. Its maintenance depends upon the continuance of a sufficiently high level of earnings to support it. This requires prediction of future earnings at the time the regular dividend is established. Since none possesses the kind of prevision that is required to prevent mistakes, the reaction against a reduction in a regular dividend may hurt the credit standing of the corporation very seriously. The longer the record of regular dividends, the more severe the shock to the credit standing if a dividend is cut. This was illustrated in the case of the Pennsylvania R.R. Co. This company had paid 6 per cent on its common stock for so many years that the continuance of this rate was seldom questioned. Investors and speculators alike looked upon this dividend as if it were a fixed return upon a bond investment. When, in 1921, the company saw fit to reduce its dividend rate to 4 per cent, the effect upon its credit was almost as bad as if it actually had failed to pay all its bond interest.

**Conservative Dividend Policy.**—Whether dividends are regular or irregular, there is much to be said for conservatism in distributions, especially if cash dividends are declared. Most American corporations plow back a part of their earnings. Many English companies pursue a more liberal distribution policy. But most English corporations do not have the opportunity for growth enjoyed by American business enterprises. In this connection, it may be questioned whether the American policy of accumulating surplus rather than distributing earnings is not frequently overdone. Large surpluses lead to overexpansion and speculation, resulting from the efforts of the corporation managers to keep their assets working.

RATIO DIVIDENDS TO NET INCOME

Invested capital classes (000 omitted)	1931	1932	1933
Under \$50. ....	42.7	60.1	36.0
50 to 100. ....	52.5	68.5	33.5
100 to 250. ....	60.9	68.4	38.6
250 to 500. ....	67.9	71.2	38.7
500 to 1,000. ....	73.6	73.9	43.5
1,000 to 5,000. ....	78.5	79.2	52.9
5,000 to 10,000. ....	86.1	87.4	60.6
10,000 to 50,000. ....	88.9	92.4	77.8
50,000 and over. ....	103.7	108.9	102.5

**Statistical Summary.**—In general, large corporations pay more liberal dividends than small corporations. The above table<sup>1</sup> is based upon all returns to the Bureau of Internal Revenue.

<sup>1</sup> The Twentieth Century Fund, "How Profitable Is Big Business" (New York, 1937), p. 77.

The available net income disbursed as dividends by the General Motors Corp. averaged 72.62 per cent for the years 1909 to 1936. In only 2 years of this period, 1921 and 1932, were no dividends disbursed. The percentage of available income disbursed in each of the other years ranged from 4.58 in 1909 to 144.38 in 1931. For most of the years, the percentage distributed approximated the average for the entire period.

**Extra Dividends.**—Conservatism in dividend policy is sometimes fostered by the payment of small regular dividends and the occasional distribution of an extra dividend when conditions warrant. The latter may be paid in cash, stock, scrip, or property. The line between regular and extra dividends sometimes disappears when a so-called "extra" dividend is declared regularly. In time, it comes to be expected as a part of the "regular" distribution. With some corporations, this is a favorite means of increasing regular dividends. For instance, suppose 1 per cent per quarter is established as the regular rate of dividends. Later, one-half of 1 per cent is added tentatively as an extra. Maintenance of the new rate of  $1\frac{1}{2}$  per cent soon causes its expectation. The regular annual 4 per cent dividend merges the extra 2 to form a regular 6 per cent declaration. Extra dividends are sometimes used by corporate managements, without labeling them as such, to induce outsiders to purchase stock. By increasing an existing dividend rate for a quarter or two, outsiders may be attracted by the higher earnings distribution of the corporation. After the insiders have succeeded in unloading the stock they wish to sell, they can easily eliminate the extra dividend, without fear of being displaced in the management of the corporation.

**Bonus Dividends.**—Sometimes "bonus" is used to describe an extra dividend that the distributing corporation does not wish to have considered a precedent. When the Distillers Company, Ltd. (of England), declared its final dividend of  $12\frac{1}{2}$  per cent at the close of its fiscal year in June, 1937, it added a bonus of  $2\frac{1}{2}$  per cent, making a total for the year of  $22\frac{1}{2}$  per cent. The total for the preceding year was only 20 per cent. The preference stock of the Belgian National Rys. Co. has a guarantee from the Belgian government for its fixed dividend. In addition, it is entitled to a super-dividend of one-half the net profits after provision for charges, one-half going to the government, which owns all the common stock.

**Dividend Cautions.**—It is not unusual for corporations, in the announcement of a dividend declaration, particularly after a period in which no dividends have been paid, to caution the stockholders that such a dividend is not to be considered a regular dividend. When Oppenheim, Collins and Co., Inc., declared a dividend of \$0.50 per share in 1937, the first distribution to its shareholders since 1932, it was careful to state that it was not wise to establish a permanent dividend schedule at that time. In declaring a \$1 dividend on its preference stock in 1936, the Peerless Weighing and Vending

Machine Corp. announced that it was to be considered strictly as a special dividend and not as an indication of a regular dividend policy.

**Interim Dividends.**—Under the urge of the undistributed-profits tax, some American corporations made adjustments in their dividend policies to avoid the penalties imposed by this tax. Among other changes was the introduction of interim dividends, long since common in England. Interim dividends are used for the first three quarters or first half year, with a final dividend, of probably a larger amount, at the end of the fiscal year. This practice interrupts a policy of regular dividends. The E. I. du Pont de Nemours & Co., Inc., followed a policy of regular quarterly dividends up to 1936. In that year, it introduced interim and final dividends. In 1937, the Timken-Detroit Axle Co. adopted a policy of declaring interim dividends, determining the amount by prevailing conditions rather than attempting to pay the same amount each quarter.

**Melons.**—Extra dividends of the spectacular type, being large in amount and infrequent in occurrence, are commonly called "melons." Melon cuttings and rumors of them are great incentives to speculation. There is sometimes a long series of rumors preceding a melon cutting. At other times, the transaction is announced suddenly and catches many unawares. It can serve useful purposes either way. As a matter of fact, the melon cutting has so often been tinged with suspicion that its appearance always causes one to question who is securing an advantage from its use.

**Dividends from Capital Surplus.**—Dividends are usually considered the distribution to the contributors of owned capital of their proportions of the gains made through the use of their capital contributions. Ninety-nine out of a hundred people questioned would give a definition of dividend which embodies that idea. The one-hundredth person probably never heard of a dividend. In other words, dividend is synonymous with distribution of profits. And so it is ordinarily intended. As already indicated, insofar as the laws deal with the subject, that is obviously what is intended.

And yet many dividend payments do no more than return to stockholders a part of their capital contributions. Properly understood and discounted by all parties concerned, there can be no valid objection to this procedure. In general, however, neither stockholders nor creditors know what is going on when a corporation declares dividends from capital surpluses. Stockholders think that they are receiving their share of earnings, and creditors do not appreciate that their equities are being diluted by the return of capital to the original contributors thereof.

In 1935, the Westinghouse Air Brake Co. reduced the stated value of its capital stock from \$47,581,661 to \$34,893,218, thereby creating a paid-in surplus of \$12,688,443. At the same meeting, the stockholders voted to distribute one-half of this surplus to the stockholders during 1936, 1937, and 1938 at the rate of \$0.25 per share per quarter.

In 1933, the Sterile Products, Inc., had a capital surplus of approximately \$15,000,000, arising from the excess of tangible assets of subsidiary companies over the par value of its capital stock issued therefor. Of this amount, approximately \$5,000,000 was allocated to the reserve for contingencies, and approximately \$1,500,000 was distributed as cash dividends to its shareholders, leaving a balance in excess of \$8,000,000 to capital surplus.

**Dividends from Appreciation.**—When assets are sold for more than their book value, the realized appreciation resulting from such sale appears to be available for the payment of dividends. Although there is no unanimity of decisions on the subject, most courts seem to hold that unrealized appreciation does not constitute a basis for dividend distribution. In this connection, stock dividends are not considered the same as cash dividends, since the former do not represent a distribution of assets.

**Return of Capital Contributions.**—Probably the most open method of distributing capital contributions is the declaration of a dividend from paid-in surplus. In 1934, the paid-in capital stock of the Flintkote Co. was reduced \$1,654,399 and, in 1935, \$2,004,138. The entire amount in 1934 and \$1,995,138 in 1935 were distributed to the stockholders. Having no earned surplus, the Byers (A. M.) Co. declared a dividend of \$2.50 per share on its 7 per cent preferred stock, disclosing the source of the dividend to be paid-in surplus. Its surplus items at the time of this declaration were as follows: capital surplus from revaluation of assets, \$1,135,051; paid-in surplus, \$9,070,730; and profit and loss deficit, \$1,108,407. A new corporation without time or opportunity to accumulate earnings can mail dividend checks to its stockholders from surplus "paid in" by them. The unsuspecting recipients do not question the source of the dividend but feel elated at their good judgment in selecting stock in such a well-managed corporation.

"Depression" dividends may arise from reductions in stated capital. A large number of corporations engage in the game of reducing stated capital, wiping out deficits, and creating surpluses in order to keep up dividend payments. Unintelligent and indifferent stockholders lend their approval to such hocus-pocus. In 1929, the International Mercantile Marine Co. eliminated its deficit and the accumulated dividends on its preferred stock by exchanging one share of new common and \$20 in cash for each share of outstanding preferred; and one-fifth share of new common for each share of outstanding common. One well-known corporation, whose directors must have a sense of humor, recently reduced its capital account 83⅓ per cent and transferred this amount to the surplus account. At the same meeting that witnessed the final touches to the transfer, the directors solemnly declared a dividend of 1½ per cent on the reduced amount of stock outstanding; the dividend was in stock. In other words, each stockholder was asked to donate to the surplus account of his corporation 83⅓ cents of each capital

dollar. He was then given back  $\frac{1}{4}$  cent of the same capital dollar—in a residual claim against the same capital.

In the chapter on Surplus and Its Uses, various other methods of returning the capital investment of a corporation to its contributors are suggested. If properly understood and discounted, there can be no valid objection raised to such dividends, provided all parties concerned have their interests protected. Indeed, a corporation with wasting assets may well pursue a policy of returning capital to its owners as the resources of the corporation are exhausted. It is the secrecy and implied misrepresentation that are objectionable. Also, creditors may suffer from such declarations at times.

**Borrowing to Pay Dividends.**—If a corporation has satisfactory accumulated earnings, tied up in assets other than cash but without the expectation of permanent capitalization, it may be possible and even desirable to borrow money with which to pay dividends. The law recognizes the right of corporate directors to borrow for this purpose. As a rule, the right should be sparingly utilized. If all other conditions are favorable, borrowing to maintain a regular dividend payment would seem to be advisable. Under less favorable conditions, borrowing to pay dividends might easily prove fatal to the financial stability of the corporation.

**Dividend on No-par Stock.**—Dividends on no-par stock are declared at so much per share, the same as dividends on par stock. This presents no complication. However, complications arise from another source. The proceeds from the sale of no-par stock are commonly carried to two accounts: stated capital and some form of surplus. The latter, on occasion, is the basis for dividends. It appears that the law against dividends which impair capital can be circumvented by paying them out of a surplus arising from the sale of stock. The laws that liberalize the use of no-par stock do not establish new definitions of capital except insofar as the laws are concerned. Economic definitions and their consequences remain the same as in the use of par stock.

**Dividend Policies of Holding Companies.**—Holding companies have problems all their own involving dividend policies. They are dependent upon dividends and other payments from subsidiaries for their income. At any particular time, however, only a part of the subsidiaries may be enjoying profits, while the others are suffering losses. The parent company has a responsibility for operating losses of its subsidiaries. Hence the profits from successful units may be absorbed by losses of the unsuccessful, leaving little or nothing for dividends on the stock of the holding company. Subsidiary losses should be scrutinized carefully before the income of the parent company is dissipated in dividends.

**Liquidation Dividends.**—In the above discussion, it is indicated that dividends are usually thought of as distributions of profits. In a sense, every cash dividend may be looked upon as a liquidating dividend since it

results in a decrease in the assets of the corporation. Its opposite would be an assessment that increases the assets. Stockholders and others interested in the welfare of the corporation take just the contrary point of view from that expressed here. Large and frequent cash dividends attract purchasers of stock; assessments repel prospective investors.

As pointed out, however, much of such distribution may more properly be called "capital" dividends. In either event, they are distributed by going concerns. Liquidation dividends, on the other hand, represent distribution of assets by business enterprises that are going out of business. Upon dissolution of the General Stockyards Corp. in 1937, when the assets were sold to the United Stockyards Corp., holders of preferred stock received the redemption price of \$107.50 per share plus \$0.246 accrued dividends. Holders of common stock received a liquidation dividend of \$28.94 per share. Sometimes securities are distributed among the stockholders. In 1936, the Advance-Rumely Corp. declared a liquidation dividend of \$1 in cash and one-half share of stock of the Allis-Chalmers Manufacturing Co. Having determined to sell its assets to the Electric Auto-Lite Co., the Corcoran Brown Lamp Co. issued a liquidating dividend to the holders of its A and B stocks, consisting of one-half share of Auto-Lite stock for each share held.

Assets hard to divide are often converted into cash, and the remainder thereof, after payment of debts and expenses of liquidation, is distributed as a liquidation dividend. In the process of closing out the corporation's affairs, several liquidation dividends are frequently declared, the aggregate of which is usually considerably less than the amount originally invested by the stockholders. It is conceivable that a successful enterprise might liquidate at more than investment values. Such possibilities rarely become actual in corporation finance.

Liquidating dividends on the Gauley Coal Land Co. 6 per cent cumulative preferred stock have been paid as follows: July 1, 1930—\$50 per share; Jan. 1, 1931—\$30; May 1, 1931—\$10; Oct. 1, 1931—\$9. Accrued dividends have been liquidated as follows: Apr. 16, 1934—\$40 per share; Oct. 31, 1934—\$25; Mar. 1, 1935—\$25; Dec. 2, 1935—\$6; Feb. 28, 1936—\$6; July 15, 1936—\$24; and Jan. 4, 1937—\$10. After making full provision for the preferred stock, the common stockholders of Amoskeag Co. were given the right in 1927 to receive in exchange for each share \$52 in cash, \$40 in 6 per cent bonds, and one common share of the Amoskeag Manufacturing Co.

**Bond Liquidation Dividends.**—Liquidation dividends may be paid to bondholders as well as to stockholders. If they are paid to the former, the chances are good that the latter will receive nothing. The proceeds from the receiver's sale of the National Radiator Corp. were sufficient only to pay a liquidating dividend of \$213.66 per \$1,000 debenture bond. The first mortgage gold 6½s of the Parker Young Co., due 1944, were retired in 1936

by settlement at \$0.37½ on the dollar. In 1937, the first sinking fund 6s of Price Brothers and Co., Ltd., a Canadian corporation, were retired at 107½ plus accrued and unpaid interest, amounting to \$141.30 for each \$100 principal amount of bonds. The company had been in bankruptcy since 1933. It was reorganized in the early part of 1937.

**Rights of Preferred Stockholders.**—The legal rights of preferred stockholders are quite complicated at times. In general, since much preferred stock is nonparticipating, it is interested only in cash dividends. If it is noncumulative as well, its holders should have definite interest in the determination of current earnings as contrasted with accumulated earnings. Its rights to dividends under such circumstances are determined by this definition. As indicated in an earlier chapter, the position of preferred stockholders is not well protected because the control of the corporation is usually in the hands of common stock. Accounts may be so manipulated as to favor the latter instead of the holders of preferred stock.

It happens not infrequently that the interests of the preferred stockholders and those of the holders of the common stock are directly opposed to each other. If all goes well with the corporation and both receive dividends, the preferred stockholders have no cause for complaint if the common stockholders are paid a higher rate. Presumably, this is the compensation for taking the greater risk. But if there is doubt about the payment of dividends on the preferred stock, the conflict begins. Then it becomes a matter of great importance to the preferred stockholders to make sure that the accounting procedure for determining net earnings is honestly and efficiently administered. For on this question may depend the future payments to the holders of the preferred stock.

Even where earnings are admitted, the board of directors still have the right to determine whether or not they shall be distributed in any specific year. The board may decide instead that the corporation's welfare demands the retention of the earnings. If the preferred stock is cumulative, it stands a fair chance of a later distribution. Although, as was pointed out in an earlier chapter, the larger the accumulation of unpaid dividends, the less the likelihood that they will ever be paid in cash. If dividends on the preferred stock are noncumulative, failure to pay them in a year when they are earned raises some interesting questions. Assuming that the board of directors decides to refuse to pay noncumulative earnings in a year when they are earned, may it merely retain these earnings in the business temporarily with their subsequent distribution to the preferred stockholders? Or may the board later pay to the common stockholders the earnings that it refused to pay to the holders of the noncumulative preferred stock? Justice would seem to be on the side of the preferred stockholders when an issue of this kind is raised; but the law may support the claims of the common stockholders.



It should be added that courts are seldom called upon to pass on such issues. The common stockholders more often than not dominate boards of directors. Where there is any conflict in the points of view between the two classes of stockholders, the directors are most likely to support the side of the common stockholders. Preferred stockholders may not like the decisions, but they are not very articulate in expressing their objections. And mere passive objections seldom deter boards of directors from expressing the will of those whom they represent.

### QUESTIONS AND SUGGESTIONS

1. Do proprietorships and partnerships declare dividends? Explain.
2. Why is it necessary to distinguish between profits and capital in a corporation?
3. Who determine the dividend policies of a corporation? What legal restrictions limit their discretion? How may such laws be evaded? Are they ever ignored?
4. What is an unlawful dividend? What happens if an unlawful dividend is declared?
5. How does English practice in the declaration of dividends differ from American? How has the use of no-par stock changed American practices?
6. What factors do boards of directors consider in determining dividend policies? Which are most important? Why?
7. What changes in public policy influence dividend declarations?
8. How do taxes affect dividend rates? Give examples.
9. How does the "judgment" of directors affect their decisions in declaring dividends?
10. Is it a good plan for directors to explain to stockholders changes in dividend policies? Why?
11. Is it desirable for corporations to pay regular dividends? Why?
12. What are the arguments for a conservative dividend policy?
13. What is an extra dividend, and why is it used? What do the English call it?
14. What are interim dividends? Do you recommend their use? Why?
15. What is a melon? Why is it used?
16. What is the true character of a dividend paid out of an appreciation surplus?
17. What are "depression" dividends, and why are they used?
18. Is it ever desirable to borrow money to pay dividends? Explain.
19. How do liquidation dividends differ from other kinds?
20. What complications sometimes surround the payment of dividends on preferred stock?

### SUPPLEMENTARY READINGS

- BUCHANAN, N. S.: "The Economics of Corporate Enterprise" (New York: Henry Holt and Company, Inc., 1940), Chap. IX.
- BURTCHETT, F. F.: "Corporation Finance" (New York: Harper & Brothers, 1934), Chap. XXXIII.
- DEWING, A. S.: "Financial Policy of Corporations" (New York: The Ronald Press Company, 1941), Book III, Chaps. IX and X.
- GUTHMANN, H. G., and H. E. DOUGALL: "Corporate Financial Policy" (New York: Prentice-Hall, Inc., 1940), Chap. 22.
- LINCOLN, E. E.: "Applied Business Finance" (New York: McGraw-Hill Book Company, Inc., 1941), Chap. XXIII.
- MEAD, E. S., *et al.*: "The Business Corporation" (New York: D. Appleton-Century Company, Inc., 1941), Chap. XXVIII.
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**SUBJECTS FOR INVESTIGATION**

1. From the corporate news section of the *Commercial and Financial Chronicle* or other similar source, find five corporations which have increased their dividends. Account for the increases. You may be required to look at previous years instead of current reports.
2. Find five corporations which have decreased or eliminated their dividends, at least temporarily. Account for the decreases. You may need to look at reports for previous years.
3. Find three cases of extra dividends, and account for their declaration.

## CHAPTER XXXIII

### KINDS OF DIVIDENDS AND THEIR USES

**Definition.**—Dictionaries define dividends in terms of “sums of money,” “quantities of property,” etc. In fact, in the minds of most people, a dividend is a distribution of assets, usually cash. Financial practices sanction no such narrow definition. The best that can be said is that, in corporation finance, dividends represent a distribution of the book surplus, accompanied by a distribution of assets, by a change in the form of equities, or by an increase in liabilities of the corporation. In other words, many dividends do not affect the assets side of the balance sheet at all.

In a study of the period from 1920 to 1939, it was found that manufacturing corporations, as a class, paid out in dividends \$3 out of every \$4 of their net earnings. Trade corporations paid out about two-thirds of their earnings in dividends. Railroads paid out about the same proportion as trade corporations, although in the second decade of the period they paid out, as a class, more than they earned. The American Telephone and Telegraph Co. paid out about 90 per cent of its net earnings.<sup>1</sup>

Dividend distributions by manufacturing corporations are more regular than net profits, as is shown by the table<sup>2</sup> on page 586.

**Cash Dividends.**—Unqualified statements about dividend declarations usually carry the implication of cash distributions. People who buy stock for investment hope for regular distributions, in cash, of proportionate shares of the earnings of the corporation whose stock they own. Spectacular distributions in cash are rare and are not expected. The cash dividend represents merely the normal expectancy in corporate income distribution. Up to three decades ago, a large proportion of the total amount of dividends declared was in the form of cash. Within the last three decades, stock dividends have become almost as great, in the aggregate, as cash dividends. According to an investigation of 2,846 corporations by the Federal Trade Commission, cash dividends for the 7 years preceding 1920 accounted for 82 per cent of the total amount of dividends declared; stock dividends, 14 per cent; and “all other,” 4 per cent. For the 7 years beginning with 1920, the corresponding percentages were cash 53, stock 47, and a negligible amount of all other.

<sup>1</sup> Koch, A. R., “The Financing of Large Corporations” (New York, 1943), pp. 83–84.

<sup>2</sup> Compiled by the National Association of Manufacturers, from statistics published by the United States Bureau of Internal Revenue. Published by the N.A.M. in “The Record of Manufacturing Profits” (New York, 1942), p. 23.

NET PROFITS, DIVIDENDS, AND RETAINED NET INCOME  
All Manufacturing Corporations, 1923-1940 (000,000 omitted)

Year	Net profits	Dividends	Income retained
1923	\$3,174	\$1,761	\$1,413
1924	2,418	1,651	767
1925	3,245	1,908	1,337
1926	3,212	2,116	1,096
1927	2,673	2,226	447
1928	3,460	2,507	953
1929	3,954	2,575	1,379
1930	877	2,613	(e) 1,736
1931	(d) 913	1,894	(e) 2,807
1932	(d) 1,827	1,115	(e) 2,942
1933	77	1,010	(e) 933
1934	778	1,221	(e) 443
1935	1,508	1,580	(e) 72
1936	2,570	2,321	249
1937	2,545	2,529	16
1938	931*	1,344*	(e) 413*
1939	1,900*	1,700*	200*
1940	2,500*	2,000*	500*

\* Estimated.

(d) means deficit.

(e) means excess of dividends over net profit.

**Security Dividends.**—The percentages quoted on page 585 indicate the relative insignificance of kinds of dividends other than cash or stock. Nevertheless, it is important to indicate the possibilities. Security dividends may be of various kinds:

1. Securities of subsidiaries may be distributed to the stockholders of the parent company. In 1936, the common stockholders of the American Commercial Alcohol Corp. were given, as a 20 per cent security dividend, 5 per cent cumulative preferred stock of the American Distilling Co.

2. Securities of a parent company, held in the treasury of a subsidiary, sometimes form the basis for dividend distributions. For several succeeding quarters, the directors of the American Cigarette and Cigar Co. declared a dividend of one-fortieth or one-twentieth of a share of common B stock of the American Tobacco Co. In 1935, the 7 per cent secured gold notes of the Consolidated Textile Corp., amounting to \$2,807,487, were purchased by a subsidiary for \$1,000,000 and subsequently declared as a dividend by that company to the parent company. Thereupon, the notes were canceled.

3. Securities held purely for investment are sometimes distributed as dividends. Munitions companies during the First World War accepted

Liberty bonds in payment for supplies. Some of these were distributed to stockholders. In 1917, the American Brake Shoe and Foundry Co. declared on its preferred stock a "Red Cross" dividend of \$1 and an extra dividend of \$5 in Liberty bonds.

4. Property no longer needed for operations is sometimes exchanged for the securities of another corporation. These may become security dividends.

5. New property is sometimes acquired in the name of a new corporation, whose stock may then be divided among present holders.

6. The total assets of a corporation may be exchanged for the stock of another, which in turn may be distributed in the form of a security dividend.

7. Occasionally, a court or a regulatory commission orders a corporation to divest itself of control of another corporation. Distribution of stock among the holders of shares in the holding corporation may accomplish this purpose.

What amounted to a security dividend was distributed to the holders of the stock of the Southern Pacific Railroad Co. when it incorporated its oil lands under a separate charter. To meet the requirements of the Hepburn Act, it then distributed its oil stock to its own stockholders. Since, however, it had invested more than \$50,000,000 in the oil lands, it asked its stockholders to pay \$15 per share for the oil stock. At that price, the stock was undervalued so that the sale was somewhat like a security dividend.

8. Preferred-stock dividends on common stock once became very popular as a means of beating the tax on undistributed profits. In 1936, Safeway Stores, Inc., issued 5 per cent cumulative preferred stock, par \$100, as a dividend to its common stockholders. In 1936, the Alaska Pacific Salmon Co. issued, to its common shareholders, \$20-par cumulative preferred stock entitled to \$1 per year dividend, as a dividend of \$4 per share. The common stockholders were given two options: (1) one share of preferred to each five shares of common; or (2) three-fourths share of preferred and \$5 in cash to each five shares of common.

In 1937, the California Packing Corp. issued 5 per cent cumulative preferred stock as a dividend to its common stockholders. In 1936, the Caterpillar Tractor Co. offered \$25,000,000 of 5 per cent cumulative preferred stock, par \$100, to provide a method of getting credit for paying undistributed earnings and thus avoid the 1936 tax while retaining in the business cash that would ordinarily flow out in dividend payments. The shareholders were given the option to take cash or preferred stock. In 1937, it declared, on its common stock, a dividend of  $\frac{3}{4}$  share of preferred stock.

**Bond Dividends.**—In rare cases, corporations have declared dividends in the form of their own bonds or short-term notes. Such a policy may effect either one of two purposes: (1) the conservation of cash; and (2) the inducing of preferred stockholders to accept the corporation's promise to pay in place

of cash dividends due. By this means, the holders of preferred stock may be bought off from taking over control of the corporation through the suspension of their dividends.

In order to avoid the penalty imposed by the Federal tax on undistributed profits, the Parker-Wolverine Co. planned to pay future dividends partly in cash and partly in debentures, thus retaining a reasonable portion of its cash without tax penalty. In November, 1937, it declared a cash dividend of \$0.25 per common share and \$0.75 in 2 per cent 5-year convertible debentures.

In 1936, the Pan American Petroleum and Transport Co. issued 7-year 3½ per cent dividend notes as a dividend on its common stock. Austin, Nichols and Co., Inc., declared a \$5 dividend on its prior-preference A stock, payable \$1 in cash and \$4 in notes of the company. By this means, it retained most of its cash and evaded the tax on undistributed corporate profits.

**Property Dividends.**—Dividends in property other than securities are even more infrequently used than are security dividends. The assets of a corporation are usually not divisible into units corresponding to the number of shares of stock outstanding. Special cases, such as the distribution of unsold lots by a real estate development corporation, occasionally come to light. Much publicized announcements of dividends in barrels of whiskey, declared by distilling corporations in recent years, are examples of property dividends. In effect, most of these dividends were not really property dividends, since the legal complications surrounding the actual withdrawal of the whiskey from the warehouses made it necessary for most dividend receivers to sell their dividend warrants rather than withdraw the whiskey for their own use.

**Scrip Dividends.**—Scrip dividends are promises to pay at some future time the dividends declared now. They are an admission of the corporation's lack of cash. In recent years, they have been superseded in part by stock dividends, though the effects of the two are quite different. Scrip dividends may be used to hide the weak credit position of the corporation. This excuse has pretty well been discredited. The declaration of a scrip dividend is now considered an evidence of weak credit. Nevertheless, scrip dividends may be justified under either of two sets of circumstances:

1. If a corporation has been paying, in cash, a regular dividend and if its affairs are essentially sound, the stockholders are entitled to a continuance of the dividend payments. Should the profits be in the form of accounts and notes receivable, for instance, it might be better for the corporation to owe the stockholders for the amount of the dividend instead of borrowing from its banker. Under these circumstances, the corporation can commit itself to a cash distribution in the future and evidence its good faith by distributing to the stockholders promises to that effect. It would be more difficult to

justify the initiation of a dividend policy by the use of scrip than the continuation of a policy already in use.

2. By the use of scrip dividends, present stockholders are permitted to share present profits. If the corporation is growing rapidly, it might wish to conserve its cash for capital additions. Postponement of all dividends, under such circumstances, will benefit future stockholders but may not help present holders, unless stock prices reflect the accumulation of earnings.

**Kinds of Scrip Dividends.**—The kinds of scrip dividends are numerous. Some have a due date; the payment of some is contingent upon a future event, such as the sale of an issue of bonds; others are mere promises to pay, at the discretion of the board of directors. Some bear interest; others do not. Some are convertible into stocks or bonds. In anticipation of conversion into stock, some scrip dividends may participate in future cash distributions.

Dividends on the cumulative Class A participating common stock of the Porto Rican American Tobacco Co. of New Jersey, from 1912 to 1921, were paid partly in scrip, as follows: 1912—scrip 20 per cent; 1913—cash 8 per cent, scrip 10; 1914—scrip 20 per cent; 1915—cash 12 per cent, scrip 5 per cent; 1916—cash 22 per cent; 1917—cash 8 per cent, scrip 8 per cent; 1918—scrip 9 per cent;<sup>1</sup> 1919—scrip 6 per cent; 1920—scrip 12 per cent; 1921—scrip 3 per cent. In 1936, the company still carried a part of this scrip on its balance sheet as a liability.

**Stockholders Become Creditors.**—Since the scrip-dividend warrants are, in form, promissory notes, the holder thereof becomes a creditor of his corporation. Unlike the stock dividend, the scrip warrant is expected to be retired. At the time of its retirement, the corporation's obligation on account of the dividend expires. The obligations assumed with the issuance of stock dividends are expected to continue indefinitely.

**Stock Dividends.**—The great popularity of stock dividends in recent years cannot be accounted for by any simple explanation. Since, according to the definitions usually given for a dividend, a stock dividend is a misnomer, its increasing use is a matter of considerable interest to students of corporation finance. A stock dividend has no immediate effect upon assets. It represents a transfer of credit from the surplus account to the capital stock account. This transfer is usually accomplished by the issuance of additional shares of stock to evidence the dividend declaration. The stockholder has a larger number of shares after the dividend than before. But his equity in the business has not changed in amount. It has merely been divided into a larger number of pieces.

The size of a stock dividend is limited by the amount of the surplus and by the amount of unissued stock. The latter is easily increased by a charter amendment. Treasury stock is sometimes distributed in the form of dividends. The Bon Ami Co. in 1937 declared on its Class A stock an extra

<sup>1</sup>Plus 4 per cent stock.

dividend of \$2 in cash and one-hundredth of a share of Class A stock; on its Class B stock \$1 each and one two-hundredth share of Class A stock. The stock distributed was treasury stock.

**Purposes of Stock Dividend.**—Stock dividends may be issued to serve one or more of the following purposes:

1. *Selling Aid.*—A corporation with stock of questionable value may overcome sales resistance by promising and even “guaranteeing” large annual dividends—to be paid in stock—although the form of the dividend is not always emphasized. Through the use of no-par stock with low stated value, the stockholder may enjoy a large stock dividend the first year of the corporation’s life. The fact that the dividend is not a measure of the corporation’s earning power is of little significance to the average stockholder who does not know what his corporation’s policies mean.

2. *Marketability.*—The stock of an existing successful corporation may meet sales resistance because of its high price. The stock dividend gives the holders of such stock a real market advantage. Such an advantage is particularly attractive to speculatively minded boards of directors. Stock split-ups may serve this purpose as well and need not be concerned with the size of the surplus.

3. *Conservation of Cash.*—A stock dividend permits the corporation to give its stockholders evidence of the prosperity of their company without giving them cash which may be needed for other purposes.

The Sun Oil Co., for the decade ending in 1936, pursued a policy of declaring as dividends on its no-par stock a fixed annual cash distribution of \$1 per share and in addition the following stock dividends: 1927—3 per cent; 1928—6 per cent; 1929—9 per cent; 1930—9 per cent; 1932—3 per cent; 1933—9 per cent; 1934—9 per cent; 1935—7 per cent; and 1936—6 per cent.

4. *Pacifier.*—Boards of directors find the stock dividend a means of pacifying stockholders who clamor for dividend distributions, a change in management, and what not. An occasional distribution of a few shares of stock as a dividend may quiet the insistent demand for more tangible evidence of the corporation’s success.

5. *Veiling of Profits.*—Huge profits translated into a high rate of dividend return upon a relatively small amount of stock sometimes arouses the opposition of buyers of the corporation’s products. This is particularly true with public utilities. A sizable stock dividend may enable the corporation to distribute the same amount of profits spread over a larger number of shares of stock and at a lower dividend rate.

6. *Evasion of Taxation.*—Legislators are as naïve as stockholders in visualizing the surplus as a “pile of cash in the back room.” Ever-increasing demands for government revenue make legislators look with covetous eyes at large surpluses. Indeed, the Internal Revenue Act of 1928 gave the com-



missioner authority to tax, at the rate of 50 per cent, the net incomes of corporations that continue to accumulate unnecessary surpluses. This temptation to taxgatherers can be removed by the transfer of much of the surplus to the capital stock account.

The General Capital Corp. took no action on dividend declaration in the middle of 1936, preferring to wait until December, when it would be in a better position to determine the amount of dividends necessary to escape the surtax under the Revenue Act of that year. At the same time, the Crosley Radio Corp. postponed dividends on its no-par common stock until its directors had further opportunity to study the effects of the same law.

**Effects of Stock Dividends.**—Whatever the purposes of stock dividends, certain definite effects follow their declarations. The surplus distributed by stock dividends becomes a part of the permanent investment of the corporation. The stockholder's equity is not otherwise affected. He has a larger number of shares of stock than before, but each is worth proportionately less.

The stock dividend is commonly known as a "melon." The letters are all right, but in many cases they should be rearranged to spell "lemon." Not only does a stock dividend fail to distribute the assets of the corporation, but, if it absorbs an appreciable part of the surplus, it may prevent future cash dividends until a new surplus has been built up from future earnings. Hence a melon is really a lemon so far as cash dividends are concerned.

**Stock Dividends and Creditors.**—If the stock dividend is merely a substitute for a cash dividend, the creditors of the corporation may be the real beneficiaries. In the first place, the conservation of cash strengthens the credit position of the corporation. In the second place, capitalization of surplus by means of stock dividends increases the permanent margin of safety for the creditors. However, if the rate of cash dividend paid on the stock previous to the stock dividend is maintained on the increased amount of stock due to the stock dividend, the creditors may be harmed rather than helped if the increased demand for cash to meet dividend requirements represents too great a drain on cash resources.

**Stock-dividend Rates.**—Stock-dividend rates cover a wide range, from small fractions of 1 per cent to several thousand per cent. Some corporations declare small regular dividends in stock, either related to cash dividends or independent therefrom. The former results in gradually increasing the cash distribution to stockholders, without much publicity. Large and irregular stock dividends give occasion for the use of the term "melon cutting." Such dividends are commonly as large as 50 or 100 per cent or more.

Stock dividends were paid on the common stock of the Erie Steam Shovel Co. as follows: in common stock—500 per cent in 1907; 50 per cent in 1916; 400 per cent in 1922; in preferred stock—50 per cent in 1924; 80 per cent in 1925. The company was consolidated in 1927 to form the Bucyrus-Erie Co.

A rapidly growing company may find the use of large stock dividends a means of permitting its shareholders to participate in its growth, without attracting too much attention to increasing profits. For example, the Goodyear Tire and Rubber Co. increased the amount of its outstanding stock by the use of stock dividends as follows:

Year	Per cent of stock dividend	Number of shares outstanding
1910	100	9,988
1911	100	19,976
1912	100	39,952
1913	...	79,904
1914	100	79,904
1915	20	159,808
1916	...	175,000

The company acquired and retired some of its stock in 1916. In spite of this the number of its shares increased nineteenfold in 6 years through the use of stock dividends.

**Fundamental Principles.**—The open-handed generosity exhibited by boards of directors in recent years in distributing large stock dividends raises questions about their knowledge of the fundamental principles governing the game that they have been playing. Small dividends by conservatively managed corporations with growing earnings create no real problems. Large distributions by relatively young corporations, whose earnings are still uncertain, cause doubt of the ability of corporations to follow through these large stock dividends to their logical conclusions.

The only justification a board of directors can give its stockholders for withholding earnings in the form of cash is that their investment by the corporation will bring greater future profits than if the individual had direct control over them. Indeed, every stock dividend carries an implied promise that future cash dividends will be proportionately greater because of the permanent capitalization of the surplus. Unless the directors have reasonable grounds for holding out this hope, the wisdom of large stock dividends is open to serious doubt. The existence of a book surplus, which gives legal sanction to a stock dividend, does not justify the dividend from the standpoint of sound business practice. Other conditioning factors should be present also.

**Kinds of Stock Used.**—Much of what has been stated above about stock dividends assumes that dividends are paid in common stock to common stockholders. That has been and still is the most frequent use of this kind of dividend. In addition, however, there are the following kinds of stock dividends: preferred stock dividend on common stock, common stock dividend on preferred stock, and preferred stock dividends on preferred stock.

These kinds of stock dividends came into use during the period from 1936 to 1939 when the undistributed profits tax was on the statute books. In an attempt to conserve their cash and at the same time avoid the penalties of this tax law, corporate managements took various means to declare stock dividends which they hoped would be acceptable to the taxing authorities as representative of income distribution.

**Effect of Income-tax Decision.**—The income-tax decision, in the case of *Eisner v. Macomber*,<sup>1</sup> had a profound effect upon the use of stock dividends in this country. In effect, the court—by a vote of five to four—declared that stock dividends are not income for tax purposes. This decision was followed by a veritable flood of stock-dividend declarations, as pointed out in the early part of this chapter. The Federal Trade Commission, in a study of 2,846 corporations, found that the stock capitalization of these corporations increased over 140 per cent in the first seven years after the decision was rendered. The surplus of these corporations, per dollar of capital stock, was \$0.60 in 1913, \$1.07 in 1920 (the year of the decision), and \$0.53 in 1926.

In the case cited in the preceding paragraph, there was only one class of stock outstanding. The court decided that to issue more stock pro rata to these same stockholders merely divided their equity into a greater number of parts and that the stock dividend did not really change the equity of the common stockholders. Subsequent decisions have produced the following results with respect to the taxability of stock dividends: A preferred-stock dividend on common stock is taxable when there is both preferred and common outstanding at the time the dividend is declared. A common-stock dividend on preferred stock is taxable under similar circumstances. And where both common and preferred stock are outstanding, a preferred-stock dividend on preferred stock is taxable. In all these cases the stockholder who receives the dividend is in a different relationship to the corporation than he was before the dividend was distributed.

**Optional Dividends.**—In rare instances, a corporation declares a dividend payable in either cash or stock, at the option of the stockholder. Sometimes cash dividends are applied toward the purchase of new stock unless the stockholder expresses a desire for the cash. He is apt to feel optimistic toward his corporation at the time the dividend is declared and be willing to buy new stock, particularly since the corporation makes the first payment in the form of a dividend.

The Philadelphia and Reading R.R. used optional dividends as early as 1863. Nearly always, the stockholder must elect the choice of dividends offered. When the General Public Utilities, Inc., offered \$3 per common share in cash or one-fifth share of common stock, the holder received cash unless he elected stock. The Wurlitzer (Rudolph) Co., on the other hand, offered to liquidate \$36.75 cumulated dividends on its preferred stock by a

<sup>1</sup> 252 U.S. 189 (1920).

payment of cash or one and one-half shares of common stock, \$10 par, plus \$6.75 in cash, provided that practically all agreed to accept the latter alternative.

Optional dividends are sometimes used to escape taxation. In 1937, the General Refractories Co. declared a dividend, payable at the option of the holders of common stock at \$2 per share in cash or 1 share of common stock for each 25 shares held. The purpose of the option was to avoid \$460,000 Federal surtax on undistributed profits. If the corporation used its earnings to pay off its bonds, the surtax would be assessed. Payment of the earnings as dividends rendered the entire dividend taxable as income to the stockholders, but, to the extent the stockholders elected to take stock instead of cash, the corporation could apply an equivalent amount of net earnings for the current year to the further reduction of its bonded indebtedness without tax penalty. The amount of interest saved could be used to pay dividends on the new stock.

**Stock Split-ups.**—Similar to stock dividends are stock split-ups. A dividend is, presumptively, a distribution of surplus, although no-par stock corporations might declare a "dividend" without affecting the surplus. The latter operation is more commonly called a split-up. It can apply to either par or no-par stock. For example, should a corporation having outstanding stock with a par value of \$100 per share call in such stock and issue twice the number of shares, each having a par value of \$50, this would be a stock split-up. In like manner, should no-par stock with a stated value of \$2 per share be called in and double the number of shares be issued with a stated value of \$1 per share, this too would be a stock split-up. In neither case is the surplus account disturbed.

The primary purpose of stock split-ups is a wider distribution of shares. Reduction in the market value of high-priced stock facilitates trading, provided that the result of the split-up is not to place the stock in the "cat and dog" class. Experience demonstrates that lower stock prices, but within the trading range, increase the number of stockholders. Other purposes of split-ups are to conceal the distribution of large profits by reducing the rate per share; to facilitate the future sale of stock issues; to prepare for corporate mergers; to please stockholders, who accept such action as indicative of financial success; to permit listing of stock; to change from par to no-par stock; and to facilitate manipulation by insiders.<sup>1</sup>

The increase in the common stock of Woolworth Co., from 500,000 shares of \$100 par when the present company was incorporated in 1911 to 9,703,613 shares of \$10 par outstanding in 1936, was accomplished entirely through stock dividends and split-ups. The original par value of the Baltimore American Insurance Co. of New York was \$100. This was reduced to \$10

<sup>1</sup> Dolley, J. C., Common Stock Split-up—Motives and Effects, *Harvard Business Review*, October, 1933, pp. 70-81.

settled this question at the time of splitting its common stock 10 for 1 by increasing the votes per preferred share from 1 to 10, thus maintaining the same relative voting strength as before.

### QUESTIONS AND SUGGESTIONS

1. What do you understand by a dividend? What does the "man on the street" understand by this term?
2. What proportion of earnings are paid out in dividends?
3. For manufacturing corporations as a class, which are more regular, net profits or dividends?
4. What are security dividends, and why are they used? What are bond dividends, and when are they used?
5. How common are property dividends? Why?
6. What are scrip dividends, and why are they used? What kinds of scrip are used?
7. In what manner do stockholders become creditors?
8. Is a stock dividend really a dividend? Explain. What are the purposes of a stock dividend? What are its effects?
9. How do stock dividends affect the rights of creditors?
10. At what rates are stock dividends declared?
11. If you owned a share of Goodyear Tire and Rubber stock in 1909, how many would you own in 1916, assuming that you kept all stock dividends but made no additional purchases meantime?
12. What fundamental principles are sometimes overlooked in stock-dividend distributions?
13. How can directors justify the use of stock dividends if the corporation has cash that could be distributed?
14. What kinds of stock are used in dividend declarations?
15. What was the decision in the case of *Eisner v. Macomber*, and how did it affect the use of stock dividends?
16. What are optional dividends, and why are they used?
17. Differentiate between a stock dividend and a stock split-up? Which is more common? Why?
18. What is a reverse split, and why is it used?

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## SUBJECTS FOR INVESTIGATION

1. From the Dividends Declared section of the *Commercial and Financial Chronicle*, compare the amount and kinds of dividends declared in a recent month with those declared in the same month 5 years ago. Account for any differences that you find.

2. Select any industrial corporation balance sheet. Show how it would be affected by the declaration of a stock dividend equal to half the surplus of the corporation. Show how it would be changed by a 2 for 1 stock split-up.

3. From the corporate news section of the *Commercial and Financial Chronicle*, using several recent issues, record as many kinds of dividends as you can find. Account for each.

# PART V

## EXPANSION AND INTERCORPORATE RELATIONS

### CHAPTER XXXIV

#### CORPORATE EXPANSION

##### MOTIVES FOR EXPANSION

**Point of View.**—Expansion is not primarily a financial problem. It involves questions affecting all departments of business, and the determining relationships may not be financial in character. In one case, transportation is the limiting factor; in another, labor; and in another, raw materials. In none of these, perhaps, is the financial department ever asked for a plan or even an opinion. Wherever other conditions are favorable, financial considerations will be taken into account. The progress of expansion programs should end, rather than begin, with finance. The financial department should be depended upon for answers to two questions: (1) How should the expansion be financed? (2) When should the expansion program be undertaken? In other words, if the other departments of the business favor an expansion policy, the method of accomplishing it becomes a financial matter. Also, the period of the cycle should be taken into account in undertaking such a program. Many expansion plans, otherwise justifiable, have been failures because they were poorly timed.

**Meaning of Expansion.**—Expansion means enlargement of the operations of a business enterprise. In the case of a manufacturing corporation, this may include taking over some of the functions exercised by others in the production and/or distribution of the products sold, without any increase in the amount of goods handled. It may contemplate extension of the market for goods into new territories and more intensive cultivation of markets already served in order that more products may be sold. Or it may include the production and sale of new lines of products not now manufactured by the corporation wishing to expand.

One or more of these purposes may be served by more intensive use of facilities already in the possession of the corporation, by the construction of additional facilities, or by the absorption of facilities already constructed but possessed by others. The methods of expansion are various and will be discussed in later chapters.

**Why Expand?**—It is well known that those most directly concerned with putting a policy into effect spend least time in speculating upon the myriad ramifications of its consequences. Given favorable conditions, expansion comes as naturally to a businessman as does discussion of it to an academician. Few of the latter would find so much interest in the thing itself as in the speculation about its results. An even smaller proportion of the former would elect to rationalize about the action in preference to participation in the action. Most expansion is based upon an unrationalized assumption that bigness is desirable. Few business executives ever set goals for themselves in the creation of their estates. The more they possess, the more they want. Indeed this is a common trait of many of those who are participants in an economic society dominated by private ownership of property. The successful farmer who has developed a comfortable living for himself and the members of his family who work with him on his farm is not content to continue as the manager of a single farm. He takes advantage of the opportunity to buy out his neighbor, even at the expense of assuming heavy mortgages on both properties, if necessary, and with the added burdens of directing hired labor. Even the prices paid for adjacent land are frequently too high to permit a net return that will be equal to that obtainable on competitive investment opportunities.

So in business expansion. There is a general assumption, seldom checked by careful analysis, which gives full weight to all possible unfavorable factors, that the larger the enterprise, the greater the satisfaction its managers receive from controlling its operations. Outsiders may question the economic justification of the great size of some of our industrial giants. Insiders are not concerned by such questions. Even the editors of financial publications sometimes raise questions about the continued growth of some of America's largest corporations. Such questions are ignored by the managers and the growth continues.

In some lines of business, the manager has little choice. In order to keep in the competitive race for business, he must expand in the hope of lowering his costs. Even governmental pressures, such as those imposed by higher taxes, urge operators of business enterprises to try to offset added costs by widening the scope of their operations. Not all the hoped-for economies of large-scale operation are realized. Nevertheless, they are attempted as a matter of course in many lines of business.

**Expansion and Economic Theory.**—It is not probable that business leaders have never heard of marginal utility; decreasing, constant, and increasing costs; diminishing returns; optimum size; economic equilibrium; etc. On the contrary, many of them have studied these questions in college. At the time, they no doubt sounded plausible, and their presentation carried conviction. No doubt, also, these business leaders could be convinced of the soundness of these doctrines. It is quite doubtful, however, that acceptance



of such theories would prevent expansion or even operate in a major way to chill the interest in a given expansion program.

Even statistical evidence of the fact that diminishing returns are the reward of too great expansion fails to carry conviction in regard to a specific situation. After all, responds the business executive, statistics at best deal with averages and averages always overlook the peculiarities of the individual situation. Even if, on the average, too great expansion is not profitable, the particular case at hand possesses qualities that no other similar expansion program ever enjoyed. This case is different from the average: so reasons the businessman whose judgment about a specific expansion program is challenged.

**Motives for Expansion.**—Business leaders are sometimes thought of as impersonal machines whose motive power is the desire for financial gain. The profit motive is undoubtedly a dominant one in the minds of all businessmen, but it alone cannot account for all efforts at business expansion. Some motives that play an important part in dictating expansion policies are not economic in nature. Those that may be classed as economic will be discussed first and will be grouped under the heads of production, distribution, administration, and finance. This attempt at analysis of the motivating forces that bring about expansion does not imply that business leaders always follow a careful pattern of checking all angles of an expansion program before they embark upon it. As has already been suggested, most business executives assume, without careful analysis, that expansion is desirable. This assumption is just as active whether the point from which an expansion program starts represents a relatively small scale of operations or a large scale. Nevertheless, there is always in the background some more or less general concept of the economic gains that are expected to flow from an expanded program. In the discussion of the economic advantages that are expected to be gained from expansion, we must necessarily deal with potentialities. In specific situations, a part of the hoped-for gains may fail of realization, perhaps for reasons not controlled by the fact of expansion.

**Production.**—Production advantages hoped for from expansion programs include the following:

1. Reduced material costs and steadier prices through the use of larger purchasing power. The buyer of a large quantity of goods always has a bargaining advantage over his smaller competitor, unless the conditions of manufacture require him to make long-term commitments in advance to ensure delivery of the proper amounts as needed. These long-term commitments may give the smaller competitors a bargaining advantage in the spot markets at times of falling prices.

2. In the smaller units of business enterprise, the managers are Jacks-of-all-trades and masters of none. Large-scale operations permit the substitution of skilled management for unskilled and afford each department head an

opportunity to develop to the highest degree his specialized knowledge of his field.

3. Similarly, large-scale operations permit minute division of labor and specialization of human operations. Time and attention can be given to the training of each man for the specific duties required of him. Too minute subdivision may dull the wits of the operatives and retard their development. However, suggestions for improvement in methods and processes seldom come from the operatives. With specialization of work, the management is expected to supply this need.

4. Plant specialization may be accomplished by concentrating the production of a single part or of a few parts in one plant. Various economies are expected to result from this practice.

5. Plants producing complementary products may be grouped in such manner as to produce most economical results. This is particularly true of expansion accomplished by construction. When one corporation absorbs the plants of another, geographical location may not favor economical grouping of plants. This may affect also plans for plant specialization.

6. Large-scale operations permit the use of expensive laborsaving machinery not available to small production units. The size of the run and the cost of setting up machinery for it always affect the kind of machinery that may be utilized effectively. Large capital investments would not be justified in the production of small quantities of goods.

7. Where the operations of a corporation are sufficiently extensive to warrant their departmentalization, the results accomplished by the various units may be compared. The most effective standards developed in each may be adopted for all.

8. Small-scale concerns are frequently forced to consider as waste that which a large-scale enterprise may develop as a by-product. Profits are sometimes measured in terms of effective uses of by-products. The utilization of, and experimentation with, by-products result in the creation of new industries. By-products at one time have become main products at another.

9. Small enterprises have neither the personnel nor the resources to experiment with new products and new methods. Large-scale units make much at times of their research departments. It appears likely that industry will rely more in the future upon organized, purposeful research than upon accidental discoveries.

**Distribution.**—Constant improvements in production, resulting in new and better products manufactured in large quantities at less cost, have created major distribution problems which are continually pressing for solution. Expansion helps to solve some of them and, on the other hand, creates new problems. Wider markets are made possible by lower production costs and, in turn, they are expected to permit more even demand for goods distributed at lower unit costs. Expansion in sales is expected to

result in lower advertising and other selling expenses per unit of goods sold. Wider distribution, on the other hand, creates problems of financing sales that may be difficult to solve. Should the expansion of sales approach monopoly control of markets, the monopoly profits resulting therefrom might increase materially those available under competitive conditions.

**Administration.**—At first blush, it appears that with increase in size of a business enterprise, the greater complexity of organization must result in greater administrative costs. This is undoubtedly true in the aggregate. Offsetting this, however, are two factors to be taken into account: (1) An increase in aggregate administrative expenses may not result in an increased cost per unit of output. (2) Recognition of the tendency to increase overhead costs may set up an antidote in the form of constant effort to find new ways of minimizing such expenses.

**Finance.**—By finance here is meant the financial advantages of large-scale operations as contrasted with those of small business units. In addition to the financial advantages of operation, expansion is frequently undertaken because of the appeals made by financial motives. (This subject is discussed in the next paragraph.) Large-scale operations permit more economical issues of securities because they command a wider market. Ease of financing in turn results in lower costs because larger sums are available for the purchase of laborsaving appliances. If more stable earnings result from expansion, the corporation's credit position will be improved. This in turn facilitates raising of additional capital at lower costs. The larger enterprises usually have better control over credits and collections. They should be able also to increase the turnover of their receivables by specific attention to that department of their business.

**Financial Motives.**—Expansion usually takes place during the prosperity period of the business cycle when optimism rules the decisions of business leaders and investors. Rising security prices invite speculation. The whole atmosphere of business relationships encourages preparation for the larger profits that the future seems to promise. Optimism is frequently accompanied by generosity. Those who are about to enjoy even greater prosperity can afford to be generous with their associates. As a consequence, expansion is accomplished by the liberal distribution of bonuses to all concerned. The promoter who organizes the expansion program, the banker who finances it or sells the securities for financing it, the manufacturer whose assets are absorbed in the process of expansion, and even the purchaser of the new securities offered—all receive bonuses as an inducement to participate in the expansion program. Indeed the bonus, in one form or another, plays such a large part in expansion that it completely overshadows at times all other considerations. Promoters urge expansion programs which net immediate returns to those participating but which are not justified by subsequent events. Bankers sell stocks and bonds that never become seasoned. Manu-

facturers take an apparently large profit—in securities, usually—in disposing of their plants and equipment when they sell to expanding corporations. Security purchasers buy securities in the hope of disposing of them at higher prices but with little thought of the realizable earning power behind them.

**Speculation.**—In addition to the hope for immediate or prospective gain to be derived from expansion, business leaders like to expand their operations because they obtain satisfaction from trying out new plans. The dynamic nature of business causes it to thrive on uncertainty. Uncertainty involves risk, but successful risk taking results in progress and profits. Certainly one of the outstanding characteristics of competitive capitalistic economy is the chance taking that produces changes in products and in methods of processing and distributing them. Expansion opens wider areas for speculation of this sort.

To be sure, a considerable share of the risk is borne by the stockholders and even by the bondholders who put up the money needed to finance the chances that the management takes. While the management enjoys the thrill of directing the play, the other participants are permitted to share in the results, favorable or unfavorable. This does not mean that the failure of an expansion program does not bear heavily upon the management of the corporation. They, too, stand to suffer a financial loss. Meantime the managers have had the privilege of testing out their ideas, largely at the expense of others.

**Personal Ambition.**—Few business leaders ever analyze their aims or their actions. They do not ask themselves, Why should I undertake these new risks and assume these new responsibilities? Perhaps their subconscious minds dictate their urge to get ahead. Expansion cannot be explained on the basis of economic motives alone. Long after leading businessmen have made ample provision for all possible personal demands against their incomes and their capital, they continue to expand their businesses. Keeping up with the Joneses plays a considerable part in expansion psychology. In the absence of the laurel wreath as a mark of quality, and indeed in the absence of any definite authorized agency for bestowing rewards of any kind, American business leaders become their own judges of excellence in business leadership. As yet, qualitative measures of excellence have not been developed. Quantitative measures are more easily applied. Hence, the size of the business managed is used as the test of the capacity of the management. This helps to account for the urge to expand.

**Self-expression.**—In addition to emulating others and keeping in the race with them, every outstanding business leader seeks a method of expressing his ideas of business organization and operation, regardless of what others accomplish. Success breeds success and opens new vistas for accomplishment. Long after competition has been forgotten and profits, as such, no longer appeal, business leaders still find new worlds to conquer with the

additional resources made available through expansion. Even the plaudits of the multitude do not constitute the chief spur to effort in such cases. Self-satisfaction in accomplishment and self-expression are often more powerful stimulants than praise.

**Dangers in Expansion.**—The common urge of businessmen to expand their fields of operation does not always produce the desired results. Various causes account for the failure to succeed on a large scale after enjoying success on a small scale of operations. The management may be well adapted to small enterprises but be unable to grow fast enough in capacity to assume the increased burdens of responsibility that accompany expansion. Incidentally, the readjustments made necessary by expansion present strong arguments for slow growth in contrast to rapid expansion.

Many expansion programs are not properly balanced. It is a common fault of business leaders to provide new plant facilities without adding to circulating capital. New fixed capital usually requires additions to both permanent and temporary investment in circulating capital. Failure to provide these increases may wreck the enterprise, however satisfactory the new fixed capital may be. Frequently, the one who finally supplies the additional circulating capital acquires control over the enterprise, together with a large share of the profits to be derived from its future operation.

**Limiting Factors.**—Any of the economic reasons listed above as possible advantages to be gained from expansion may also become limiting factors if mistakes are made in expansion programs. For example, basic production elements may cause the law of diminishing returns to become operative in such manner that expansion programs are not economically justifiable. This is particularly true in extractive industries where raw materials are irreplaceable. The same situation may develop in manufacturing industries as well.

Hoped-for economies in marketing may not materialize. On the side of production, the unit cost of the article produced may be materially reduced by expanded operations. This generally means a standardized product. But, particularly where the style element is important, perhaps an unstandardized article will sell more readily. In such cases, it is the whims of the consumer rather than the low-cost production policies of an expanded industry that will dictate the kinds and quantities of things to be produced. If the expansion program will not lend itself to the production of style goods, it may not be successful. Costs of production, difficulties of transportation, or any one of several other factors may hinder the marketing of the increased quantity of goods made available by an expanded industry.

In the same manner, either lack of proper financing or administrative weaknesses may become limiting factors in an expansion program. Among other dangers to expansion programs is the failure to account for the part to be played by others. The market might afford a demand for 10 per cent

more goods. But if all competitors expand their capacity 20 per cent, not only will a part of the plants be idle, but the struggle for the business available may result in at least temporary losses for all concerned.

### FINANCING EXPANSION

**Availability of Funds.**—Business expansion is determined more frequently by the availability of funds and credit than by any other force. By availability is not meant levels of interest rates but rather willingness of owners of capital to relinquish it. In periods of depression, interest rates may be low, but the margin of security demanded may be prohibitive for most purposes. In periods of prosperity, high interest rates may attract investments in spite of great risks involved. Perhaps it would be more correct to say that at such times the risks are minimized because investors are optimistic and tend to disregard risks rather than to weigh them carefully.

In the minds of those who determine expansion policies, not even real need for expansion weighs so heavily as availability of funds. Expansion is undertaken usually under high costs of money, materials, and labor. When materials and labor are cheap, no one wants to expand his plant facilities, for he is unable to keep employed those already available. Pessimism about the future clouds possibilities for future use of increased facilities, even though funds for expansion are available. At the peak of prosperity, on the other hand, high material and labor costs are no insuperable obstacles, for money and credit are available—albeit at high costs—and the optimism of business leaders visualizes need for expanded facilities to enable them to take advantage of orders now offered to them at a time when their present facilities are being operated at capacity. Expansion at such times aggravates the difficulties of succeeding depression periods because the financial and construction burdens of such expansion are always great. The obligations attached to expansion are freely incurred in a spirit of optimism at a time when bright future prospects seem to justify them fully. They may fall due at a very embarrassing time in the future when pessimism is rife and future prospects are anything but bright.

**Sources of Funds.**—Funds for expansion may be obtained from the following sources:

1. Accumulated surplus kept in liquid form. If invested in fixed assets, the latter may afford a credit basis for borrowing, but they do not supply funds directly.
2. Conversion of assets, no longer needed in the business, into cash which can be used for expansion when needed.
3. Short-term borrowing.
4. Sale of stock.
5. Sale of bonds.

**Reinvestment of Earnings.**—As pointed out in an earlier chapter, one of the reasons why American corporations do not make current distribution of all their net earnings is the expectation of their use for reinvestment in the business. Corporations that accumulate and use earnings for expansion and limit their expansion to such sources of funds will seldom suffer greatly from a decline in credit standing and from actual or threatened insolvency. The optimism of their managements may result in overexpansion and loss of profits. But so long as the increased facilities belong solely to the corporation, the sheriff is not apt to transfer their title to others. Furthermore, if a corporation has enjoyed actual profits which are available for expansion purposes, it is less likely to embark upon an expansion program based solely upon hope. It at least has an experience background from which to judge the future. The limit of expansion from earnings is the amount accumulated for that purpose. Slow growth, rather than rapid, will result. The former involves less risk than the latter.

**Amount of Corporate Savings.**—The amount of corporate saving may necessitate changes in our economic theories about abstinence and the functions of interest payments. According to one observer, corporate savings for the seven years before 1930 averaged more than 45 per cent of net profits, provided an average of 49 per cent of new corporate capital, and, excluding public utilities and railroads, provided more than 60 per cent of new corporate capital.<sup>1</sup> Another estimate indicates that, for the period from 1920 to 1927, corporations that made use of stock dividends retained about two-thirds of their net income to be used either for absorption of other companies or for vertical or horizontal growth.<sup>2</sup> While the rates of growth are larger for small than for large corporations, even the latter depend upon savings for a large part of their continued growth, meantime perhaps distributing stock dividends to evidence their progress.

Since corporate savings become almost automatic at times, the managements of the very largest corporations tend to lose sight of specific objectives and let mere bigness complicate their problems if constant growth outstrips efficiency of operations. From time to time, investment bankers and others have pointed out the dangers of passing the point of diminishing returns. The capital stock of the American Car and Foundry Co. remained virtually unchanged from 1900 to 1925. The company financed all acquisitions, additions, and improvements from earnings.

A study of chain-store experience in reinvestment of earnings leads to some interesting conclusions. Corporations operating chain stores have seldom resorted to the sale of bonds or even preferred stocks as sources of

<sup>1</sup> Amos, J. E., "The Economics of Corporate Saving," abstract of Ph.D. thesis, p. 10, Urbana, Ill., 1936.

<sup>2</sup> Jewkes, J., Stock Dividends in Large and Small Companies, *Quarterly Journal of Economics*, February, 1931, pp. 352-357.

capital. Where the latter have been used, they have usually been subject to early redemption from earnings. Using common stock as the source of original capital, much of the expansion has resulted from retention of a high percentage of earnings. Variety stores retained 80 per cent of earnings in 1923 and 48 per cent in 1929. Grocery chains reinvested 75 per cent in 1921, 1922, and 1923 and 56 per cent in 1929. Apparently by 1929, these institutions had reached the stage of diminishing returns in reinvesting their earnings in their own business.<sup>1</sup>

During the period from 1912 to 1929, the Woolworth Co. paid out in dividends only 45.6 per cent of its earnings and reinvested the remainder. Dividends were paid each year of the period, with a 30 per cent stock dividend in 1920 and a 50 per cent stock dividend in 1927.<sup>2</sup> In 1933, the Bristol-Myers Co. adopted an expansion policy which included the acquisition of established companies and their products by the use of surplus earnings for this purpose. The Federal Revenue Act of 1936 caused a change in this policy because of its penalty on undistributed profits.

**Preinvestment of Earnings.**—More optimistic managements invest not only profits already accumulated but those hoped for in the future. Since they expect to be in possession of profits at an early date, they are tempted to borrow for short periods, using the proceeds of short-term loans for permanent investment. Such a policy avoids the disadvantages inherent in the sale of stocks and bonds but invites disaster should the hoped-for earnings not materialize at the time anticipated. In that event, not only are the earnings apt to be unavailable to repay the loan, but refinancing may become quite difficult because of tightened money markets. Preinvestment policies may be more extensively planned than reinvestment policies because optimism, rather than experience, is the basis of calculations. Expansion policies, however, may be limited to conservative estimates of future earnings. On that principle, preinvestment of earnings may be justifiable.

**Management Decides.**—It is interesting to note in passing that reinvestment of earnings and even preinvestment in expansion is determined by the corporate management and not by the stockholders. Even should the question be submitted to a vote at the annual meeting, the absentee stockholders would have permitted the management proxy holders to decide such questions for them. The widening breach between ownership and management, discussed earlier in this volume, accentuates the management point of view in the determination of such issues.

The point at issue is more fundamental than any mere question about the expansion of a particular business enterprise. It represents an attitude

<sup>1</sup>Guthmann, H. G., and K. E. Miller, Some Financial Tendencies among Leading Variety and Grocery Chains during the Past Decade, *Harvard Business Review*, January, 1931, pp. 248-254.

<sup>2</sup>Phillips, C. F., A History of the F. W. Woolworth Company, *Harvard Business Review*, January, 1935, pp. 225-236.



of mind on the part of business executives which assumes that managers of corporations are best able to determine what is best for the stockholder. The stockholder, meantime, may have purchased the stock in the hope of an income return rather than with the expectation that the management would reinvest all or a major portion of the corporation's earnings in an expansion program. As a matter of public policy, the passage of the undistributed profits tax of 1936 served notice that the Congress of the United States questions a plan of plowing back too large a proportion of corporate earnings. As is well known, this law was not a revenue-producing measure. Instead it was based upon a plan of forcing a distribution of a greater portion of corporate earnings than that dictated by corporate directors.

**European Experience.**—European experience in financing expansion differs from American experience in several particulars. Bankers play somewhat more minor roles in the management of European corporations. This alone places more emphasis upon operating profits than upon financing profits. In the second place, expansion is less of a disease in Europe than in America. While there are large corporations in England and in Germany, there are fewer of them than in America. Across the water there is more tendency to recognize the limitations of expansion areas with less tendency to organize every conceivable industry into extra-super-colossal corporations. Finally the investors in European corporations have periodic opportunities to determine whether or not they care to keep all their eggs in one basket. European corporations distribute a larger proportion of their earnings in the form of cash dividends. Expansion takes place from the proceeds of the sale of additional securities. If the stockholders elect to reinvest earnings in these securities, they may do so. They are not forced to take new securities instead of cash.

**Sale of Assets.**—Few corporations depend upon the sale of assets for financing expansion. Usually, the assets to be sold are obsolete and therefore worth little or nothing. One circumstance offers exceptions to this rule. When an industrial concern owns a valuable site in a growing city, its land may be needed for a higher and better use than that to which it is being put. It may be able to dispose of its plant and site for enough to build a larger and more up-to-date plant in a section farther out but equally suitable for its purposes.

**Short-term Borrowing.**—Funds for expansion may be obtained from the sale of short-term notes, the repayment of which is expected, not from future earnings, but from the sale of stocks and/or bonds. The expansion may be undertaken at a time when the cost of money is high and when the issuance of long-term bonds may entail indefinite financial burdens of large amount. Not only will interest rates be high, but the provisions of bond indentures will favor the lender rather than the borrower, because the former is in a position to dictate the terms under which he is willing to sell his capital. Under these

circumstances, the corporation is tempted to sell short-term notes in the hope of early refinancing under more favorable conditions. Such policies involve dangers because the notes may fall due under even more embarrassing conditions than those under which they were issued. On the other hand, dogmatic opposition to the use of short-term notes for expansion is not always justified. A corporation may be in such a strong position that it can assume the risks involved. It should at least observe the danger signals before proceeding with such a policy.

**Sale of Securities.**—When a corporation decides to sell securities for purposes of expansion, its management must give careful consideration to a number of factors before the particular type of security is selected. As a general rule, the interests of the corporation will be best served by the sale of the weakest security that the market will absorb. If preferred stock can be sold, bonds should not be offered. If common stock can find a suitable market, it should be substituted for preferred. For the first time in the history of the Victor Chemical Works, it offered common stock to the public in 1937. Previous to this time, its stock had been closely held. It has no funded debt or preferred stock. It is always comforting to know that one has an ace in the hole which may be played if needed. If the strongest securities are sold first, even with some economy in carrying charges, the corporation may be unable to raise money at a later time if needed. In making this general statement, the relative advantages of stocks and bonds should not be overlooked.

**Advantages of Bonds.**—The main advantages of bonds for expansion purposes may be listed as follows:

1. Bonds can usually be sold at less expense than stocks. Carrying less risk than stocks, they can be sold to institutional purchasers and other large bond buyers in large blocks. Such buyers as insurance companies, trusts, estates, and other institutions interested primarily in investment have no direct interest in management. Such buyers are usually holders of bonds until their maturity since they are not concerned about temporary market fluctuations.

2. Bonds usually carry rates of interest lower than dividends promised on preferred stock or expected from common stock. The carrying charges on bonds would therefore be less than those expected on stocks. The better security behind the bonds is the most important factor that accounts for the lower carrying charge.

3. The issuance of bonds does not disturb the control of the corporation, since bonds almost never possess voting rights. While new stockholders might cause no trouble, there is always a question as to their attitude toward present management until they become adjusted to it.

**Bonds Not Available.**—Not all corporations have a choice between bonds and stocks. Those without established credit standing or unpledged assets

or with highly uncertain earnings may find the market for their bonds closed. Their securities must be limited to stocks. Other corporations, such as banks and insurance companies, are prohibited by law from issuing bonds. Some state tax laws discriminate against bond issues and force the sale of stock instead. No corporation should use bonds for expansion unless it is in a mature industry and unless its earnings are fairly stable and easily forecast.

**Advantages of Stocks.**—The outstanding advantage in the use of stock is the absence of fixed charges. Failure to pay interest on bonds may precipitate bankruptcy or receivership of the corporation. If the corporation has only stocks outstanding, it may eliminate its dividends and weather economic storms. Bond issues may affect the general credit of the corporation adversely as compared with stock issues. However, this distinction should not be pushed too far. Passing of regular dividends on stock may have the same effect upon the general credit of a corporation as failure to pay interest on bonds. On the other hand, it must be conceded that an increase in assets, through the sale of stock, increases the protection of creditors and thereby increases the credit standing of the corporation. This principle applies particularly to those corporations which borrow heavily from banks or in the open market. Large bond issues may have little effect upon the current credit standing of utilities which do a prepay or cash business and have little occasion to incur large current indebtedness.

**Sale through Investment Bankers.**—Controversies arise frequently over the relative advantages of sale of securities through bankers or directly by the issuing corporation. Bankers will not interest themselves in highly speculative common stocks. However, other agencies for distributing stock may take their places. The outstanding advantages of sale through bankers are as follows:

1. Time is frequently a factor in pursuing an expansion program. By the use of bankers, the corporation may assure itself of the possession of the funds agreed upon at the time they are needed. Sometimes an expansion program is embarked upon before the sale of the securities has been consummated. Failure to sell the issue under such circumstances might prove exceedingly embarrassing to the corporation.

2. With an established clientele, distributed as widely as its market for any securities, a bank may give the corporation all the advantages of wide distribution of its securities. These include diffusion of ownership, which tends to permit concentration of control; provision of a wider market for future issues of securities to existing stockholders and bondholders; and even advertisement of the products, since security holders always have a definite interest in the success of the corporation in whose securities they are investors.

3. It is probable that the sale of securities through bankers is usually less expensive than sale directly by the corporation. There are exceptions

to this rule. But, on the whole, the amount paid to bankers represents compensation for distinctive services which the corporation is not organized to perform for itself. It has no clientele other than its existing stockholders and bondholders, no organization trained and equipped to distribute securities, and no experience in such activities.

4. Many security sales involve exchanges for more seasoned bonds or stocks. The seller of the new securities must, therefore, be a dealer in securities generally, who can get his money back, perhaps, only through a series of operations that involve the tying up of capital for a considerable period of time. This the corporation may be unable to do. Its alternative would be to sell for cash only or to sacrifice any securities its agents might take in exchange for its own stocks or bonds.

5. The corporation might be successful in competing with others in the distribution of the products that it manufactures but enjoy less success in competing with the bankers who sell stocks and bonds of other corporations. Investors seldom buy stocks and bonds on their own initiative. They must be sold such commodities. It stands to reason that the most capable and experienced salesmen of stocks and bonds are in the employ of bankers. Hence, in competition with them, the agents of a corporation might find themselves very much handicapped in trying to sell its securities directly.

**Timing of Security Sales.**—As already indicated, funds are most available when owners of capital are most optimistic. At that time, however, construction costs, including both material and labor, are high. Furthermore, labor is least efficient when there is the greatest demand for it, and material quality is lowest when the demand is great enough to move without difficulty all that is produced. Also, expansion at the peak of prosperity is not apt to be needed until the succeeding period of depression has spent its course.

A few corporations with foresighted managements pursue a policy of raising capital for expansion when it is most available but postpone its expenditure until costs of material and labor go down. When du Pont sold 500,000 shares of \$4.50 cumulative preferred stock in 1937, the corporation had no specific use for the proceeds at the moment. Rather it announced that it appeared "prudent to raise additional capital at this time." In 1937, the Socony-Vacuum Oil Co., Inc., arranged to sell to fire insurance companies \$75,000,000 18-year 3¼ per cent debentures at 98. The proceeds were to be added to working capital, to meet bank loans, and to provide for prospective capital expenditures over the next 3 years. They are then able to get better material and better workmanship at considerably lower cost. Furthermore, if they are fortunate in timing their construction, they will probably be able to use it without much loss in idle time. If industrial leaders generally could be induced to follow such a policy, it would go far toward solving the problems of the business cycle. Refusal to expand at the peak of prosperity

would reduce the slope and the height of such peaks. An aggressive policy of expansion at the bottom of the cycle would do much to fill the troughs of depression. Thus the oscillations of the cycle would be lessened at both ends. Foresight and courage are necessary before such a program can be put into effect. Few are able to forecast major swings of the business cycle. Refusal to take advantage of large profits in sight at the peak of prosperity and to make provision for those not in sight during depressions would be considered by most people not as evidences of good business judgment but as indications of unfitness to conduct the affairs of large corporations.

**Expansion Cycles.**—One difficulty encountered in the timing of expansion is the failure to recognize the fundamental difference between expansion and operating problems of a business. The production cycle may be a matter of days, weeks, or months. Purchases and production policies must be timed to take advantage of changing market conditions. A production or sales budget that attempts to forecast more than a few months ahead is almost useless. Construction programs, on the other hand, cannot often be timed to meet present or immediately prospective market demands. Construction must be thought of in terms of months and years. From the day construction is started until it is completed, enough time has probably elapsed to permit fundamental changes in the demand for goods to be produced in the new plant. Since much expansion conducted at the peak of prosperity is not needed until after the succeeding period of depression, it appears that if a corporation would in a measure disregard market demands for its goods and time its expansion to the major swings of the business cycle, it would be in a better position to take advantage of low costs and still have the new facilities available when they are needed most.

It is understood that the expansion cycle starts at the point where a board of directors orders the drawings of the blueprints for the construction of new plant facilities; or, in the case of expansion by the purchase of already existing facilities, it would start when the decision for such purchase is made. From the time the blueprints are drawn until the new plant is constructed and equipped for use, many months may elapse. This time represents the expansion cycle. It may bear little resemblance to the time consumed in what we ordinarily call the business cycle.

### QUESTIONS AND SUGGESTIONS

1. Is corporate expansion primarily a financial problem? Explain.
2. What part does the financial department play in an expansion program?
3. What is the meaning of expansion? Why do corporations expand?
4. What governmental activities invite large-scale operation of business enterprises?
5. If a businessman were a student of economic theory, would he be more cautious in expanding his operations? Explain.
6. What are the economic motives for expansion?
7. What specific production economies may be effected by expansion? What distribution economies are possible?

8. How can administrative costs per unit be reduced?
9. How is finance affected by expansion?
10. What are financial motives for expansion? How does speculation affect expansion programs?
11. Are stockholders and bondholders affected by such speculative ventures? Explain.
12. What noneconomic motives result in expansion?
13. What dangers do expansion programs involve? What factors limit expansion programs?
14. Name several types of business where expansion is not likely to succeed. Why?
15. Are there funds available for business expansion? Where do they come from?
16. What voice have stockholders in determining expansion programs?
17. How does European experience with business expansion compare with ours? Why?
18. What is the importance of timing security sales for expansion purposes?
19. What is meant by the expansion cycle? Where does it begin, and where does it end?

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### SUBJECTS FOR INVESTIGATION

1. Select five well-known industrial corporations, and compare their latest balance sheets with those of 10 years ago. How many show evidences of expansion? What percentage change is represented in each case?
2. How has the expansion been financed in each case?
3. Meantime what has been the dividend policy of each?

## CHAPTER XXXV

### INDUSTRIAL COMBINATIONS

**Incentives for Combination.**—The urge to grow accounts for the desire of business leaders to absorb their competitors. It does not account for the apparent willingness to be absorbed. Competition has long been lauded as the life of trade. It is probably least effective when most needed. The philosophy that unconsciously dominates the actions of most businessmen is pragmatism. This results in opportunistic decisions rather than in insistent adherence to principles regardless of their chance of success. In other words, competition is like measles. No one is ever cured of measles—measles cure themselves. When competition becomes keen enough, it cures itself, and some form of combination results. Business leaders who are unable to obtain a whole loaf compromise on half a loaf.

Then, too, even where competition is not keen enough to force some concerns to sell out to their more aggressive and successful rivals, inducements may be offered to cause even highly successful corporations to enter into combinations with others, even to the extent of loss of identity of the leaders whose businesses are absorbed. The inducements may be sufficient to enable the deposed leaders to turn their attention to other fields, equally appealing.

**Success of Combinations.**—Observers differ in their analyses of the degree of success attained by industrial mergers. One exponent of the success of mergers made a study of 400 companies of the 1900 era and came to the conclusion that mergers and combinations of this period were highly successful owing to advertising expenditures popularizing trade-marks and brands, managerial resourcefulness, continuous improvement in manufacturing organization and marketing methods, development of new products, and ability to exploit the discoveries of research agencies.<sup>1</sup>

**More Testimony.**—Another study of the profitableness of industrial combinations for the period 1900 to 1914 draws the following conclusions: Of 34 corporations, each having more than \$10,000,000 total capitalization in 1903, the average ratio of net earnings to bonds, stocks, and surplus for the period studied ranged from 1.6 (Allis-Chalmers) to 12.3 (General Electric). The average of 6 per cent for all 34 corporations was reached by only 9.

Of the 34 corporations, 9 paid no dividends on their common stocks for periods up to 14 years. Only 6 averaged as much as 5 per cent.

<sup>1</sup> Livermore, Shaw, *The Success of Industrial Mergers*, *Quarterly Journal of Economics*, November, 1935, pp. 68-96.

The usual rate promised on the preferred stock was 7 per cent. Only 39 of 73 corporations studied for this purpose paid as much as 7 per cent. The average rate was 5.3 per cent.

Of the 34 cases studied, the common stock increased in value in 19 and decreased in 15. However, had an investor bought 1 share each in 93 large combinations in 1900—or within a year after the combination was organized, if formed after 1900—he would have paid approximately \$4,990 for the 93 shares. By 1914, they would have been worth an aggregate of \$7,040. Meantime, he would have received \$4,700 in dividends, or an average of 6.7 per cent on his original investment.<sup>1</sup>

**Historical Development.**—Industrial combinations in the United States have been concentrated into three great periods, with lesser activity in the intervening years. The first period covered the decade of the eighties and ended with the depression in the early nineties. The second period began after the election of President McKinley in 1896 and ended about 1903, having spent its momentum by that time. The third period began after the 1920 depression and ended with the collapse of the 1929 boom. Each period is characterized by different conditions and warrants brief description here.

**First Period.**—The two conditions necessary to the creation of the first combination period arose after the Civil War. The first was the tremendous development of the means of transportation and communication; the second was the wide use of interchangeable parts in the production of goods. The latter made possible mass production, and the former permitted extension of markets in disposing of larger outputs. Recovery from the depression of the seventies was accompanied by the first wave of industrial combinations. The results startled the people as a whole and led to a veritable storm of protest, which took the form of hysterical legislation in an attempt to stamp out the new monster. State after state enacted antitrust laws, and the Sherman Act was passed by Congress with the almost unanimous approval of both houses. The number of outstanding combinations of this period was not large, but the policies pursued by some of them dramatized their effects in such manner as to invite widespread opposition to all manner of industrial combinations.

One outstanding characteristic of the period was the dominance of the operating executive in the combinations that took place. Of the outstanding leaders in the movement, none were bankers or financiers. All were operating executives who sought either the economies hoped for from combinations or the advantages of monopolistic control over prices and output.

The outstanding individual whose name is associated with this first period is undoubtedly John D. Rockefeller. His exploitation of the oil industry through the various Standard Oil interests attracted nation-wide attention. Other well-known combinations of this period included the

<sup>1</sup> The Twentieth Century Fund, "How Profitable Is Big Business" (New York, 1937), pp. 105ff.



American Sugar Refining Co., the General Electric Co., and the United States Rubber Co.

**The Second Period.**—The depression of the nineties brought to a close the first period of industrial combinations. During the depression, there was little incentive for consolidating industries for whose products there was little demand. The relation between politics and business is well illustrated in the campaign of 1896. McKinley was the apostle of big business, while Bryan championed the debtor classes. The victory of the former ushered in the second period of industrial combinations. During the years from 1897 to 1903, hundreds of combinations were effected, in spite of the Sherman Act. Various causes contributed to the decline of the combination activity after 1903, including the Northern Securities decision against holding companies, but probably the greatest contributing cause was the absence of something to combine. Nearly all industries had been encompassed by the orgy of consolidation from 1897 to 1903.

Unlike the earlier combination period, the second period produced the financier-promoter of combinations, who took the place of the operating-executive leadership of the first period. The financier was not merely the agent who facilitated the combination. He took the initiative in forming the combination, often in the face of opposition from operating executives, and, in some cases, displaced the latter in subsequent management. It was in this period that the banker began to exercise a dominant part in the affairs of industrial corporations. Economics of operation and monopolistic control were still the objectives, together with the financing profits to be obtained from the sale of securities of the new combinations.

The individual whose association with this period of industrial combinations has received the greatest publicity was probably J. P. Morgan. As the active promoter of America's first billion-dollar industrial giant, the United States Steel Corp., he brushed aside the skepticism of operative heads of some of the component operating companies and emerged as the dominant figure in the organization of industrial combinations of his time. His success in putting together this combination of steel corporations invited participation in similar combinations in other industries. Whatever may have been the disappointment of investors and speculators who purchased the securities distributed by the House of Morgan as a result of the combinations in which he participated, his name stands out as the leading promoter of combinations in the second period. Some of the combinations for which he was responsible were dismal failures. Others enjoyed greater successes.

After 1903, the combination movement subsided very definitely due to several reasons. (1) It had spent its momentum by combining most of the enterprises that appeared to be susceptible to combination at that time. There was little left for the promoters of combinations to work on. (2) The market for the securities of combinations showed evidence of being tired.

The huge profits promised to the purchasers of securities of combinations had not materialized. Prices did not respond as intended. The purchasers wanted more proof that they had made wise commitments before they bought more stock of a similar kind. (3) The decision of the Supreme Court of the United States in the Northern Securities case, decided Mar. 14, 1904, called again to the attention of promoters and others that an expressed public policy in this country favored competition among industrial corporations rather than its elimination by combinations.

Between 1903 and the end of the First World War, several important combinations were effected. Some of those that are best known today, like General Motors Corp., for example, were born during this period. But there was no great wave of combinations in the period from 1903 to 1920 that compared with what happened immediately before or immediately after this period of comparative quiet. In number, the total combinations formed in the second and third periods were far greater than the total formed in the intervening years.

**The Third Period.**—The third period began in the recovery from the postwar depression. More or less consistency characterized the combinations of the years preceding the First World War. Some of those organized since 1921 can be justified perhaps on the ground that they were financial successes at the time; but they would have difficulty in finding justification on any other grounds.

In other words, the third combination period, even more than the second, is a period of dominance of the financier-promoter. With wages high, with large investable surpluses, with the whole country going stock-minded, security markets had difficulty in satisfying speculative demands, except at high prices or with new securities provided by new combinations. The latter responded nobly and kept boiling an already overheated pot. New securities of new combinations added fuel to the fires of speculation; and the ever-widening contagion of speculative fever created increasing demands for new securities of new combinations. The results were two: the greatest speculative boom America has ever experienced, and the greatest period of industrial combinations history has recorded. Many of the combinations disintegrated as soon as the speculative fever subsided. Since securities were frequently purchased on margin, or on installments, this decline was just a question of the ability of the financial structure of the country to maintain credits at a high level. As soon as the credit structure collapsed, the combination period was at an end.

One interesting feature of the third period was its apparently limitless scope. Combinations in earlier periods had been confined largely to industrial enterprises and railroads. In the last period, financial institutions, amusement companies, distribution industries, and public utilities were included also. Hardly any sizable line of economic endeavor was missed.

**Contributing Causes.**—The contributing causes of the third period of combinations may be briefly summarized as follows:

1. Politically, the national government was in the hands of those who favored the rapid development of the resources of the United States and who were not opposed to the utilization of large corporate units to that end. The First World War had given America some markets which she sought to hold in the face of what appeared to be a great struggle by European nations to regain such markets in the years following the Armistice. Possible foreign opposition helped to weld nationalistic sentiment at home.

2. Judicially, the courts had not given too much encouragement to the activities of trade associations which had been formed in large numbers during the second decade of this century. If trade associations could not be used to temper the effects of competition, mergers apparently received judicial sanction so long as "unreasonable" restraints of trade did not follow. Meantime, the courts, by interpretation, had liberalized the antitrust laws to approve all but unreasonable restraints of trade.

3. Familiarity with large industrial units had driven fear of them out of the public mind. Undoubted advantages came to be appreciated, and control came to supersede dissolution in the minds of antimonopoly leaders.

4. The close of the First World War found many American industries over-capacitated as a result of construction for war purposes. The war had disrupted industrial efficiency and resulted in high-cost operations. As long as prices were high, these high costs were not felt. But with rapidly falling prices and declining demand for products, losses mounted. Combination offered a way out. It sought to control costs of raw materials by reaching downward in the industrial scale and to control the prices charged to the consumer by purchase of distribution outlets.

5. Labor had enjoyed war wages and had raised its standard of living. Restriction of immigration protected the market for its services. It continued to raise its standard of living and had a surplus which it soon found means of pouring into the stock markets.

6. Higher standards of living created demands for large quantities of goods formerly considered luxuries or convenience goods rather than necessities.

7. The war created shortages of some goods, which laid the foundation for a long period of prosperity. This in turn made security sales easy.

8. The period from 1921 to 1928 witnessed a sharp upward trend in savings. Incomes were high, and price levels for consumers' goods and services were comparatively stable. In the period from 1925 to 1929, speculative profits were unusually high.

9. Combination in one branch of industry forced combination in others. When chain stores began to absorb manufacturing processes, manufacturers retaliated by absorbing retail outlets.

**Number of Combinations.**—Probably the most accurate estimate of the number of combinations effected during the decade of the 1920's is contained in the report of the Committee on Recent Economic Changes.<sup>1</sup> Even this report does not contain a complete record. Only such combinations as were

COMBINATIONS RECORDED IN MANUFACTURING AND MINING, 1919-1928

Year	Number of combinations	Number of corporations combined
1919	89	438
1920	173	760
1921	89	487
1922	67	309
1923	67	311
1924	95	368
1925	121	554
1926	139	856
1927	207	870
1928	221	1,038

of sufficient public interest to find a place in the records of corporate news are included in the tabulations. The date of the appearance of the notice rather than the date of the actual combination is recorded. Also only combinations in manufacturing, mining, and public utilities were included in the

TOTAL COMBINATIONS RECORDED BY INDUSTRIAL GROUPS, 1919-1928

Industry	Number of combinations	Number of corporations combined
Oil.....	124	641
Coal.....	58	238
Iron and steel.....	270	1,094
Nonferrous.....	121	676
Textiles.....	104	401
Motor vehicles.....	67	300
Chemicals.....	59	296
Foodstuffs.....	128	835
Lumber and paper.....	91	419
Other.....	246	1,091

study. This disregards the tremendous number of combinations in merchandising, theaters, amusements, hotels, etc. With these limitations, the tables on this page are presented as evidence of the trend of combinations in the third period.

<sup>1</sup> "Recent Economic Changes" (New York, 1929), pp. 181ff.

In the field of public utilities the number of companies that were combined were recorded as follows: 1919—22; 1920—15; 1921—74; 1922—285; 1923—426; 1924—580; 1925—402; 1926—1,029; 1927—911; and for the first three-quarters of 1928—585. Even municipally owned utilities were sold to private combinations, the number so combined in 1926 being 201; and in 1927, 182. As is to be expected, some of the records of the later years recorded above represented combinations of combinations.

**Kinds of Combination.**—Combinations are essentially of four kinds:

1. When two or more enterprises in the same stage of production or distribution are combined, they form a horizontal combination. This is true whether or not they are in direct competition, although this is the usual reason for their combination. Examples are chain stores or a combination of two or more automobile-tire manufacturing corporations.

2. When various stages of production and/or distribution are brought together under the same management, vertical combination results. When a steel corporation absorbs ore and coal mines, steamship lines to convey its products, or finished steels mills, the result is vertical combination. This process is frequently called "integration."

3. In the third period discussed above, circular combinations were common. This term is used to describe the bringing together of products unrelated except that they use the same distribution outlets. They are usually noncompeting products so that the question of monopoly does not arise. The objective of horizontal combinations is usually to eliminate competition; of vertical combinations, to effect economies of production; and of circular combinations, to produce economies of distribution.

4. Not all industrial combinations can be definitely classified as horizontal, vertical, or circular. Some partake of the characteristics of two or three of these classes. They may be called mixed types, though one of the three may be the dominant characteristic.

**Forms of Combination.**—Industrial combination assumes various forms, among which the following are the most common:

1. Gentlemen's agreements are informal understandings expressed orally. They are the weakest of all combinations because, under pressure, gentlemen may cease to be gentlemen. Frequently such agreements cover matters of doubtful legality. For that reason they are easily broken. Also, the terms are frequently indefinite and open to misunderstanding, and, perhaps, to unintentional breach.

Gentlemen's agreements may even be more or less subconscious in character. When two or more competitors get together for any purpose, it is natural for them to talk shop. Even though there is no attempt to arrive at a meeting of minds on future policies, each is influenced in his thinking by the impression he obtains from the other. If one is pessimistic about the future, the others may reconsider their plans and become more cautious.

Trade-association conventions which discuss the business outlook may very studiously avoid any attempt at agreement upon a concerted policy. Nevertheless, those who attend are bound to be influenced by what they hear. Perhaps the use of the term "gentlemen's agreement" to define the consequences of such an exchange of opinion is stretching a definition a good ways. At any rate the effect may be just as pronounced as if an agreement had been formulated and adopted.

Perhaps one of the most famous of the gentlemen's agreements covered understandings in the steel industry. "Gary dinners" were not just opportunities for the friends of the head of the U.S. Steel Corp. to be well-fed. After the dinner Judge Gary, chairman of the board of directors of the leading steel company in the United States, told his guests, the heads of the other steel companies, what operating policies of the corporation were planned for the ensuing months. Following his statement, others present were given the opportunity to state what their companies' plans were. No formal agreements were signed, and none were presented for signature. Nevertheless, the Gary dinners led to common understandings on subjects like prices of steel products, limitation of output, etc. Under pressure from the government when the U.S. Steel Corp. was under indictment for violation of the Sherman Act, the Gary dinners were discontinued.

2. Pools are more formal and are usually in writing, though they too may be oral. The individual units maintain a high degree of independence except in the attainment of an agreed-upon goal, such as the maintenance of prices, the limitation of output, or the division of the market. Patent pools are common, even today. Profit pools, traffic pools, and the like have largely been superseded by more definite forms of combination. Territorial pools are still fairly common.

A pool is essentially a kind of agreement by which the participants agree in advance upon a division of the available business. For example, in a profit pool suppose that there are participants *A*, *B*, *C*, and *D*. Suppose that it is agreed that *A* shall receive 35 per cent of the profits; *B*, 30 per cent; *C*, 25 per cent; and *D*, 10 per cent. Then, regardless of sales or output, profits are supposed to be divided as per agreement. In traffic pools, each participating railroad is entitled to carry the percentage of traffic agreed upon. In territorial pools, each participant is entitled to the exclusive market for goods within the geographical area outlined for him. Patent pools contemplate the common use of patents owned by the participants. Various modifications of the pools described here have been used from time to time.

3. Many combinations, regardless of their form, are given the name "trust." Technically, the trust is a method of controlling the policies of the corporations concerned by means of appointing trustees who vote the stock of the corporations. The owners of the stock turn it over to the trustees,

receiving in return trust certificates, which possess all the attributes of the stock except the right to vote.

The trust was one of the earliest forms of combination used in this country. It was the means used by John D. Rockefeller to build up his position of dominance in the oil industry. This kind of combination was easy to form. Minorities could be disregarded. All that was needed was to get those who held the controlling interest in competing concerns to agree to place their enterprises under a common control—the trustees. Thereafter, while each corporation retained the form of a separate existence, in fact its policies were determined by the same trustees who acted for all other corporations in the combination. The trust served well the purposes of those who made use of it. In fact, it accomplished its purposes so well that the public reaction forced it out of existence. While the voting trust is still in use, it is seldom the vehicle for eliminating competition.

4. Community of interest is used in two senses in connection with industrial combinations: (1) to designate informal, indefinite understandings to the effect that two or more corporations will work to their mutual advantage; and (2) to describe definite contractual relations between two corporations, such as the sale of the product of one to become the raw material for the other. Either of these may be accompanied by interlocking directorates or common-stock ownership.

When the same people own stock of different corporations, it is easy to see how similar ideas might come to dominate the policies of the different business enterprises. It is to the advantage of the owners to see that the business units help each other in every way possible. This can be brought about most practically when the boards of directors of the different corporations contain common members. Even though such common members are not numerous enough to represent a majority of any board, they are in a position to influence the policies of each corporation. The possibilities of interlocking directors have been visualized by legislative bodies, with the result that laws have been passed to discourage such practices, where the probability of a substantial control over competition is present. Where interlocking directors are still permitted, it is usually with the consent of some governmental agency.

5. In a merger, one corporation absorbs another, and the latter disappears as a separate entity. Mere purchase of assets or even of outstanding stock would not constitute a merger. However, either of the latter processes may lead to a merger. As a matter of fact, mergers are frequently effected as the second step toward complete absorption of one company by another. The first step may be the exchange of stock of company *A*, for example, for the assets of company *B*. *A* thus far merely owns the assets of *B*, but the latter's corporate existence continues, temporarily. In the second step toward a complete merger, *B* distributes *A*'s stock to its own stockholders

and *B* then is dissolved as a separate corporation. As an alternative, *A* may buy up the stock of *B*. When *A* owns enough of *B*'s stock to control its policies, *A* may propose to dissolve *B* as a separate corporation and exchange *A*'s stock for *B*'s. A third alternative, by which the merger is accomplished by one single action is to take advantage of provisions in the corporation codes to bring about what is known as a "statutory merger." In such case, neither the holding company device nor the exchange of assets for stock is needed.

6. When two or more companies sell their stock to a new company, organized for the purpose of acquiring control of existing companies, the transaction is called a "consolidation." The consolidation of the Niagara Hudson Power Co. with the Mohawk Hudson Power Co. resulted in the exchange of securities of the consolidated corporation for those of the constituent companies. The English use the term "amalgamation" to describe this kind of combination. It will be seen that the consolidation form of combination is very similar to the merger. In the discussion that follows, the two forms will be discussed together, since the procedures to be followed differ but little from each other. The holding company will be discussed in a later chapter.

**Procedure in Mergers and Consolidations.**—Plans for mergers and consolidations originate with a promoter who proceeds to sell his idea to the boards of directors of the corporations concerned. Having been convinced of the desirability of the combination, they pass resolutions approving the program. Stockholders of each corporation are then called together—usually in special meeting—for the purpose of sanctioning the combination. Frequently the managements receive enough proxies to ensure the success of the plan. State statutes govern the proportion of stock necessary to authorize the merger or consolidation. Objecting stockholders may be in the unsuccessful minority and must look elsewhere than to the stockholders' meeting to protect their interests.

**Protecting Minorities.**—Stockholders have various reasons for not approving plans for consolidating their corporations with others. Some stockholders never vote. They are not objectors, but, having no basis for judgment, they refuse to exercise their right to vote. These stockholders are easily dealt with if their passive attitude is assured. Others may feel that the proposed consolidation is illegal. They can seek injunctive relief in equity courts. When the Tide Water Associated Oil Co. undertook to merge some of its affiliated companies, minority stockholders brought suit, claiming the procedure was not a merger but a sale of assets under conditions that denied the minority a right to be heard. Remedies to be asserted by courts of equity are generally more apparent than real. The ordinary minority stockholder would normally exhaust not only his patience but his resources as well while he was trying to avoid the pitfalls and over-



come the delays in the path of one litigating against powerful majority interests.

Another minority group may think the consolidation inexpedient or that it does not give adequate compensation to their particular group of stockholders. They may usually appeal to equity courts for an appraisal of their stock's value and insist upon the purchase of their equities in cash at this appraised value. Still others find in their rights as minority stockholders a source of private gain at the expense of others. Through obstructive tactics, which amount to legal blackmail, they may secure for themselves a settlement in excess of the value of their equities as the price for stepping aside in order that the merger or amalgamation may proceed. Otherwise, they may defeat the purposes of the majority by long-drawn-out court proceedings. This is particularly true if the merger or consolidation is based upon options having an early expiration date.

**Valuation of Dissenters' Shares.**—Statutes commonly provide means of evaluating dissenters' shares as of the date of the dissent. Because payment is not usually made until long after the dissent is filed, disputes frequently arise over disposition of dividends to dissenters, etc. These are minor clouds, however, in comparison with those that develop from attempts to interpret statutes which declare that the dissenter is entitled to "the value of his shares," "fair value," "fair cash value," "fair value based upon his prorata share of the value of the corporate assets," "market value," "market value but not less than book value according to the last balance sheet," etc. Many statutes seem to ignore the evaluation of dissenters' shares in terms of the worth of the corporation as a going concern, in spite of the fact that some holders of corporate shares are more interested in the yield from their capital investment than in the day-to-day price fluctuations on the stock exchange or the liquidating value of assets which are intended to produce income and not the return of their investment.<sup>1</sup>

**Position of Creditors.**—When mortgaged property changes hands in a merger or consolidation, the purchaser assumes the mortgage. That is, the specific lien of the mortgage still attaches to the property. Unsecured creditors have no such lien, but, in general, courts attempt to protect them by making the assets of the corporation at the time of consolidation responsible for the unsecured claims. In practice, both unsecured and secured creditors may suffer by consolidation. Identity of assets may be quickly lost so that there is nothing left for unsecured creditors to attach. Sometimes property acquired in combinations has only nuisance value to the merger or consolidation. It is acquired merely to rid the consolidation of competition. After acquisition, its operation may be terminated and its value allowed to decline. Meantime, the merger or consolidation may have

<sup>1</sup> Robinson, B. M., *Dissenting Shareholders: Their Right to Dividends and the Valuation of Their Shares*, *Columbia Law Review*, January, 1932, pp. 60-78.

accumulated lien obligations, which make impossible the collection of debts of the corporation whose property has been abandoned. On the other hand, assumption of debts by the merger or consolidation may add security to them and assure their payment when due.

Sometimes only fixed assets are taken over by the merger or the consolidation, leaving current assets to liquidate current obligations.

**Bases of Mergers and Consolidations.**—Presumably mergers and consolidations result from contracts and negotiations between free and independent parties. Freedom and independence are relative terms. The cream of such consolidations goes to the owner of the "separator." Seldom would all parties to such negotiations be on exactly equal footing. Mergers and consolidations are frequently defensive measures. The aggressor is in a more favorable bargaining position than the party on the defensive. As a consequence, bargaining power plays a large part in determining the terms under which mergers and consolidations are effected.

All plans assume valuation of the assets taken over. Expert appraisals, balance sheets, and income statements are given careful consideration in arriving at valuations. There is no formula for weighting these factors of value. Corporations with large asset inventories and small earning power would emphasize inventory value. Companies with large earning power but small inventory of assets would insist upon capitalization of earnings as the true basis of valuation. Sometimes outside arbitrators are used to settle differences. The job of setting valuations upon properties for the purpose of merger or amalgamation is no task for an amateur. Apparently high prices, in terms of stock in another company, may result in subsequent disappointment if other units in the combination receive even higher relative prices. A shrewd bargainer is always an asset to any corporation engaging in a merger or consolidation.

**Payment for Properties Acquired.**—In general, it is expected that properties acquired in mergers and consolidations will be compensated for by an exchange of stock for stock according to a predetermined plan. In 1935, the Pillsbury Flour Mills Co. merged four of its subsidiaries and issued its own stock in exchange for the subsidiaries' shares. Upon the consolidation of the Universal Steel Co. with the Cyclops Steel Co. to form the Universal-Cyclops Steel Co., in 1936, all stocks of the consolidating companies were exchanged for a single class of stock of the new company. In 1936, the Superior Oil Co. merged the Limited Oil Co. As a result, the 10 per cent cumulative preferred stock and the common stock of the Superior Oil Co. and Classes A, B, C, D, and E of the Limited Oil Co. were all exchanged for new \$25-par common stock of the Superior Oil Co.

Objecting minorities may be paid in bonds, or even in cash, if the latter is insisted upon. All stockholders of some corporations may receive part cash and part stock. Syndicates may be used to raise necessary cash as they

would be used in any other security flotation. Options also require some cash. Some properties may be acquired entirely by giving cash to satisfy the option price. This plan may be necessary if delays in plans may result in the expiration of valuable options before the merger or consolidation is completed.

**Purchase of Assets.**—Combination results from outright purchase of assets. The consideration may be all cash, part cash and part securities, or all securities. Cash may be necessary to induce stockholders to sell property they would otherwise prefer to keep. In case all fixed assets are sold to the purchasing company, the selling corporation may liquidate its current obligations, distribute its cash among its stockholders, and surrender its charter. Or it may use its cash to reenter business in the same or some other line of activity. If securities are exchanged for assets, the selling corporation may distribute these among its stockholders and cease operations. Or it may retain the securities in its treasury and become, in effect, an investment trust. In either event, the purchasing company may wish to continue the existence of the selling company, at least for a time, in order to retain its good will.

Various reasons may be assigned to account for the sale of assets of a corporation, some of which have nothing to do with consolidation. Its managers may wish to retire from active control and pass the responsibility for management to others. Sale of assets may be the first step in liquidation of either a successful or an unsuccessful venture. At times, sales are favored because the price offered is in excess of true value of assets. Bull markets always bring opportunities of this sort. In some instances, sale of assets merely serves to give the corporation with an unfortunate past a new name and a new start. Advantage may be taken of more favorable corporation laws of another state by selling assets of one corporation to another, chartered in the favorable state. Recapitalization may be accomplished by the sale of assets to a new corporation where other means are not feasible.

**Position of Dissenters.**—As in the case of mergers or consolidations, when a corporation contracts to sell all or a substantial portion of its assets, stockholders who do not approve of the sale or of its terms are usually given the statutory right to have the fair cash value of their assets determined judicially, provided that they act within the time limits set in the law. Since the courts may set a value higher than that agreed upon in the sale contract, the assenters to the sale may find their shares decreased by the amount needed to meet the adjudicated claims of the dissenters. Some managements rely upon the probability that the number of active dissenters, if any, will not be large. Others play safe by reserving the right to cancel the sale contract until they see whether or not there will be a sizable proportion of dissenters.

**Position of Creditors.**—When the assets of one corporation are sold to another corporation, the purchaser is usually expected to assume the indebt-

edness represented by specific liens against the property acquired. No other debts are incurred, except by agreement. In the absence of fraud or in case the purchasing corporation is something more than a continuation of the selling corporation, the purchaser is not held liable for unsecured claims. The consideration received by the selling corporation constitutes the protection to its creditors, who must be satisfied before the selling corporation is permitted to dissolve. Only where it is evident that the selling price of the assets is less than the amount needed to liquidate the obligations not assumed by the buyer would the creditors have any occasion to be consulted in the sale. Otherwise, it is assumed that the consideration received by the seller will be sufficient to meet creditors' claims.

**Arguments for Combination.**—The arguments for combination may be classed under various heads, among which the most important are the following:

1. Large-scale operations produce results that parallel the advantages of expansion of any kind. Since these have been described in the preceding chapter, they will not be repeated here.
2. Fluctuations in production, sales, and profits are reduced by combination. Regularization of production and sales policies is encouraged.
3. Successful integration will eliminate profits to others at various stages in the production cycle.
4. Patents and secret processes and methods of production and distribution can be pooled in such manner that every unit in the combination can enjoy the best procedure used by any other unit. Combinations are sometimes effected primarily to secure the use of patents or processes.
5. Plant specialization can be used wherever and whenever advantage to the combination will result. Peculiar location superiority, personal efficiency of manager and men, or any other item of advantage may be capitalized.
6. Varieties of the product distributed can be reduced if only competition has brought about the existing range of products. With competition minimized, the number of styles and brands may be reduced.
7. In some instances, savings may be made in cross shipments if plants in widely scattered areas have been combined under one management. Increased output encourages larger shipments and even special transportation arrangements.
8. In vertical combinations, production all along the line can be planned to meet anticipated demand without creating surpluses at any stage.
9. To the extent that competition is eliminated, prices, output, and selling costs may be put under definite control.

**Disadvantages of Combination.**—Both size and the elimination of competition give a false sense of security that often leads combinations into difficulty. The problems of management cumulate with size. The limiting factor to size of corporations is the inability to find men capable of managing

huge aggregates of capital and men. Writing in 1869, the editor of Poor's *Railroad Manual* (page xxxi) said:

The Pennsylvania Railroad Company operates 538 miles; the Reading, 807; the Erie, 774; the New York Central, 692 miles. It may be well questioned, however, whether much more is not lost than gained by such consolidations. Just in proportion as the mileage of a railroad is increased, will the sense of responsibility be weakened on the part of those entrusted with its management. It must be very rare indeed that parties are found competent to the management of 1,000 miles of line, the earnings of which equal \$15,000,000, upon which 10,000 or 15,000 persons are employed, and in which \$75,000,000 are invested.

Bigness encourages waste and neglect. Checks upon extravagance and inefficiency are not easy to apply if the enterprise is large and responsibility divided. Size invites envy of competitors and opposition of customers. It is generally assumed that success is often attained by climbing over others. It would be hard to convince the average man that large corporations do not always make unduly large profits.

**Lease.**—A lease is a legal document giving to the lessee the right to possess and use the property of the lessor, upon payment of stipulated rents. Leases may be for long or short terms. The essential difference between the two is not really one of time but of conditions of use. In a short-term lease, the payment is usually gross and covers, in addition to taxes and interest on investment, various services to be performed by the lessor. In the long-term lease, on the other hand, the lessee assumes all taxes, repairs, and even reconstruction costs and pays to the lessor a net amount representing interest on investment, together with the costs of maintaining the corporate existence of the lessor.

In industrial and commercial corporations, the lease is used as a substitute for investment under several sets of circumstances. In some instances, machinery and equipment are leased instead of purchased. For example, in the manufacture of shoes, much of the necessary machinery is leased from the United Shoe Machinery Corp. The lessor owns the machinery and licenses its use to the shoe manufacturers. Occasionally a manufacturer buys machinery or equipment under a lease plan similar to that described in an earlier chapter for the purchase of railroad equipment. Both industrial and mercantile corporations lease buildings for their respective uses. Chain stores, particularly in the grocery and drug businesses, frequently lease their store buildings. Corporations engaged in other mercantile businesses sometimes lease the sites on which they construct their own buildings. Producing oil and gas companies lease the land from which they extract oil and gas. While it may be said that leases are used for the purpose of expansion as above outlined, probably in few of these instances are leases used as a means of eliminating competition.

In the field of public utilities, leases are used to effect combinations, particularly in the urban transportation industries and in the distribution of gas. Unquestionably, leases that are used to eliminate competition are most commonly employed in the railroad industry. A discussion of railroad leases is included in the chapter on railroad finance.

**Protection to Lessor.**—Since the operation of the property is turned over to the lessee for the period of the lease, provided that he observes its terms, it becomes a matter of definite interest to the lessor to know the disposition the lessee expects to make of the property. Under a gross or net rental lease, its operation might be neglected to the disadvantage of the lessor. Guarantees of rental are sometimes effected, with minimum amounts stipulated. Also, plans for reconstructing the property are carefully drawn, together with posting of bonds, to ensure the fruition of the plans.

**Advantages of the Lease.**—The lessee secures the right to use property of another without immediate capital outlays and with the expectation of operating the property in such manner as to make it self-supporting; *i.e.*, it is usually the expectation that the net operating income from the use of the property leased will more than pay all rentals. No new financing is necessary under the lease except, possibly, for improvements upon the property leased. The lease may become valuable whenever present or prospective income therefrom exceeds the rental agreed upon. Its sale or assignment may net a satisfactory profit to the lessee.

The lessor's stockholders, under a fixed rental, become in fact debenture bondholders of the lessee corporation. Even under a contingent rental, they are usually relieved of the responsibility for fixed charges. All improvements made by the lessee become the property of the lessor at the expiration of the lease, except by specific agreement to the contrary. At times, indeed, the cost of such improvements places the lessee in the position of the man who had the bear by the tail and did not dare let go, yet could not hold on. If the lessee defaults in the terms of the lease, the improvements made by him upon the property revert to the lessor. If he continues to make rental payments in the face of accumulating operating deficits in order to protect his investment in these improvements, he may become bankrupt in the process. When the lessee is faced with these alternatives, changes in the lease are usually requested and frequently granted by the lessor since, if the lessee cannot make the payments under the original lease, others may not want to take over the lease if the lessee defaults.

**Disadvantages of Lease.**—Aside from the burden just mentioned, in case operations under the lease prove unsatisfactory, the lessee faces other possible disadvantages in making leases. A 99-year lease, renewable forever, contemplates a long period of time. Future contingencies are hard to anticipate. The industry itself may become obsolete. New situations, not contemplated in the lease, may arise. Agreement by the lessee to pay all future taxes may

invite disaster. Carelessly drawn leases and even carefully drafted ones, which do not anticipate unforeseen and unforeseeable conditions, involve frequent and bitter controversies in the courts. Obligations assumed by the lessee may be difficult to meet because of adverse financial conditions, beyond his control.

To the lessee, the obligations under a long-term lease constitute a form of trading on the equity. If the lease is profitable, the stockholders of the lessee benefit. If it is unprofitable for any reason, the charges assumed under the lease are comparable to any other fixed charges. Such charges not infrequently are so heavy under adverse circumstances that they lead to the financial reorganization of the lessee corporation. The results are no different than they would have been had the lessee owned the property instead, provided it could have financed it with a bond issue equivalent to the rental base.

Meantime, the lessor also is bound by the lease. Alternative uses of his property he may not consider because he has pledged its possession and use to the lessee for the term of the lease. By the expiration of this term, the alternative uses may no longer be available. All increments of value in the use of the property accrue to the lessee, except such as are anticipated at the time the lease is drawn. And should the lessee have the option to purchase the property—a common provision of long-term leases—such increments may be permanently lost to the lessor.

**Trade Associations.**—A loose form of combination, which is intended to produce unity of action among corporations, without control, is the trade association. By interchange of information, each member is expected to know better the conditions that face his industry and, by intelligent use of this broader knowledge, to temper the effects of competition. Following the second consolidation period, described in a previous chapter, trade associations were tried on a wide industrial front, especially in the decade beginning in 1911. The World Wars gave encouragement to trade associations through the necessity for industrial cooperation, in order to expedite the filling of orders for war materials. The activities of trade associations vary with the industry and its problems. A useful bulletin published by the Chamber of Commerce of the United States lists 68 major activities of trade associations, some of which have several subdivisions. The most common activities listed for associations of manufacturers are statistics, business standards, elimination of unfair competition, publicity, legislation, accounting, standardization, tariff, public education, and technical research.

Most of these activities affect competition, directly or indirectly, and tend to make the trade associations similar to other forms of business combination. In fact, during the decade mentioned above and extending well into the succeeding decade, it appeared that trade associations might become the successors to the older trusts and holding companies. The Federal gov-

ernment in various ways lent encouragement of various kinds to the trade-association movement. Several conditions conspired, however, to shift the interest of industrial leaders from trade associations to the formation of mergers and consolidations in the 1920 decade. The more potent conditions causing this change were as follows:

1. A series of court decisions left doubt in the minds of industrial leaders as to the legality of trade-association activities useful to them. It appeared that the law sanctioned actions by mergers and consolidations which it opposed when carried out by trade associations.

2. Trade associations have difficulty in weathering depressions. The pressure for business during such periods breaks down rules and agreements and forces individual decisions to replace collective action.

3. Since trade associations do not affect corporate structures of the members, they afford no financing appeals and provide no fuel for stock-market conflagrations. Promoters and financiers find little in the trade-association movement to satisfy their desires for financing profits. Mergers and consolidations, on the other hand, constitute both meat and drink for this group of business leaders.

**Export Associations.**—One type of trade association has enjoyed somewhat greater success than others and has been looked upon with less suspicion by courts and regulatory commissions. This is the export association, one of the results of the First World War. The Webb-Pomerene Act of 1918 gave specific sanction to such associations in order to afford American industries better opportunities to compete with those of other nations in the race for world trade following the First World War. Many American corporations are not equipped to conduct foreign trade successfully and find these associations quite useful. In general, many acts that are considered illegal when applied to domestic trade are given the approval of the government when performed by export associations.

**Miscellaneous Combinations.**—A very loose kind of combination is the independent chain of retail outlets which may be described as a defensive alliance of independently owned and managed retailers who band together against what they consider to be the encroachments of chain stores. As a good example, the Independent Grocers Alliance serves its members by assisting them with advertising procedures, store layouts, credits and collections, and merchandising methods generally. Purchases are concentrated through affiliated jobbers. In the I.G.A., each store retains its financial and managerial independence but depends upon the Alliance for guidance and suggestions.

The cartel is a kind of gentlemen's agreement among competitors to limit competition among its members. Various devices are used to effect its purposes. Patent pools, price arrangements, territorial pools, output pools, and the use of a single selling agency are all utilized by different cartels.



Some cartels are domestic only, while others are international in their scope of operations. It is the latter type, particularly, which have received much adverse criticism during and after the period of the Second World War. In some products—such as chemicals, rubber, steel, and tin—a very high degree of international control has been exercised. In a bulletin on the subject of the control of cartels, published in 1945 by the Institute on Postwar Reconstruction of New York University, it was estimated that 200 cartels dominate as much as 30 per cent of the world's trade. Nations differ in their attitude toward cartels. Prewar Germany used them as a part of their methods of conducting economic warfare; Great Britain has given them considerable encouragement; while in the United States we have had a vague feeling of opposition to them, without doing anything about it.

### QUESTIONS AND SUGGESTIONS

1. Is the incentive to grow the same as the urge to combine? Explain.
2. What has been the success of combinations?
3. Summarize the characteristics of the first period of industrial combinations.
4. How did the second period differ from the first?
5. Why did the combination movement subside after 1903?
6. What was the Northern Securities case, and what was its significance?
7. What new factors were present in the third period? What were its contributing causes?
8. Characterize the attitude toward business of the presidents who were in office during the third period.
9. Account for the large number of public utilities combined during the third period.
10. What are the common kinds of combination?
11. What forms of combination are commonly used? Contrast gentlemen's agreements with pools.
12. What were the Gary dinners? Why were they discontinued?
13. In what two senses is the term "trust" used?
14. Differentiate between a merger and a consolidation. How are minorities protected in either case?
15. Who determines the value of dissenters' shares?
16. How may the purchase of assets be used as a substitute for a merger?
17. What is the position of creditors in case assets are sold?
18. What are the advantages and the disadvantages of combinations?
19. In what manner is the lease used as a form of combination? What are its advantages and its disadvantages?
20. Account for the attitude of different countries toward cartels.

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## CHAPTER XXXVI

### THE HOLDING COMPANY

**Significance.**—A form of combination that is at once flexible and easily undertaken is the holding company device. To many people, the holding company has become the hallmark of manipulation and of legal piracy in financial affairs. The publicity given to the exploits of some of the notorious holding companies of the decade of the 1920's has left the impression that the holding company device *per se* is iniquitous. Rather it affords another instance of what too frequently is evident in the financing of business enterprise: viz., that a perfectly legitimate pattern of organization, intended to serve a useful purpose in aiding the plans of managers and investors, has been perverted to serve the narrowly selfish desires of a few insiders whose profit is offset by the losses of their victims. The holding company plan of organization should not be condemned out of hand. Its application to particular situations should be carefully scrutinized, however.

**Definition.**—The so-called “pure” holding company is sometimes contrasted with the parent company. The former is not an operating company but controls and directs the affairs of its subsidiaries. The amount of stock ownership necessary for this purpose varies. In a few instances, majority ownership of the voting stock would be necessary. In most cases, ownership of a minority interest only—surprisingly small in some cases—would be sufficient to control the affairs of a subsidiary whose remaining stock, not owned by the holding company, is in the hands of widely distributed owners not interested in control.

In contrast to the pure holding company, the parent company is an operating company that also owns a controlling interest in other companies which are usually engaged in performing one stage of operation on the product manufactured by the parent company or in serving part of the territory, as in a transportation system. Where several layers of holding companies exist in the same system, presumably it would be proper to speak of grandparent companies and even great-grandparent companies. All the common stock of the Koppers Co. is owned by Koppers Associated, Inc., whose common stock is entirely owned by Koppers United Co., which is controlled by the Coalesced Co. and the Aloxite Corp., which in turn are controlled by the Mellon interests.

It is not easy to construct definitions of these two types of companies that are not open to question. Bonbright and Means define a holding company

as "any company, incorporated or unincorporated, which is in a position to control, or materially to influence, the management of one or more other companies by virtue, in part at least, of its ownership of securities in the other company or companies."<sup>1</sup> Control is not always direct. Either a parent or a holding company may be in a position to influence, rather than control, the affairs of a subsidiary. The line between influence and control cannot be sharply drawn. In other cases, one company may own stock in another company without attempting either to influence or to control its decisions. This situation hardly merits the name of holding or parent company.

Most holding companies control the policies of at least two operating companies. Occasionally, for purposes other than the control of competition, a holding company may have only one subsidiary. The holding company may be domiciled in one state or country, while the subsidiary may have obtained its charter from a different political unit. Or the purpose of organizing the holding company may be one of those described later in this chapter.

**Dealing with Minorities and with Creditors.**—Unless a holding company owns all the stock of its subsidiaries, it must observe and account for the rights of minority stockholders. So long as the policies of the holding company meet the approval of the minority groups, no problem is presented. But, should the controlling interests undertake to put into effect plans that do not meet with the approval of the minority, conflicts are likely to occur. Courts stand ready to protect minority interests when the latter are being imposed upon. Injunctions are sometimes obtained to prevent the holding company from putting into effect some policy that would work against the interests of the minority.

Even creditors may find relief from the actions of the holding company which are intended to defeat the contents of creditors' claims. If it appears that the controlling interest is trying to run the affairs of the subsidiary in a manner that would cheat the creditors, relief may be had by an appeal to the courts. In such cases the courts are likely to look at the substance as well as the form. They are particularly concerned with such questions as the adequacy of the capital of the subsidiary, the independence of its records, its right to conduct its normal operations without undue interference from the holding company, and the actual separation of the parent and the subsidiary in such manner that there are two corporations rather than one.

**Extent of Corporate Ownership.**—Ownership of stock of other corporations is very common in American experience. In many instances, even in the case of the ownership of the entire stock of one company by another, the

<sup>1</sup>Bonbright, J. C., and G. C. Means, "The Holding Company" (New York, 1932), p. 10.

public is not accustomed to think in terms of holding company relationships. For example, the Ford Motor Co. owns subsidiaries. Yet the public thinking is not accustomed to include this corporation in the holding company family. When the holding company idea is under discussion, it is more likely to be in terms of the pure holding company. Yet the discussion seldom distinguishes between the two forms. While most of the large industrial corporations in this country are holding companies, parent companies outnumber pure holding companies nearly four to one.

**Right to Hold Stock.**—In the United States, corporations have no inherent right to hold stock of another corporation unless such right is implied by other expressed powers. For example, a financial institution that lends money may therefore find it necessary to acquire ownership of collateral in case of default in the loan. Otherwise, the right to hold stock in another corporation must be granted by statute and must be stated in the corporation's charter. Statutes of the various states differ on this question. In some, corporations are given the right to own stock in other corporations engaged in the same business; in others, the right to hold stock in other corporations is not limited; in yet others, the statutes are silent on the question.

While there are scattered examples of holding companies throughout the nineteenth century, the most significant use of this form of organization began in 1888. At a time when the remainder of the country was expressing its opposition to business combinations by amending state constitutions and passing state and Federal laws against such combinations, the state of New Jersey alone refused to be stampeded by the hysteria of the times. With political leadership dominated by capitalistic interests, it broke away from the trend of legislation being enacted by other states and in 1888 by constitutional amendment gave corporations the right to own, hold, and dispose of shares of stock in the same manner and with the same privileges as individuals. In the next year, this constitutional permission was made effective by enabling legislation. From then until the passage of the Seven Sisters Acts in 1913, New Jersey favored the incorporation of holding companies. The change in 1913 was short-lived, and in 1920 the Seven Sisters Acts were repealed. By that time, other states had enacted legislation to compete for the corporation business enjoyed by New Jersey.

The pattern set by New Jersey was followed in some other states. Some indeed went even farther than New Jersey in bidding for holding company favors. Meantime, it has been only recently that a reaction against holding companies has swung the pendulum in the opposite direction. The legislation against the holding company as such is discussed in a later chapter.

**Purposes of the Holding Company.**—One or more purposes motivate the promoters of holding companies. The most obvious are the following:

1. Two or more independent companies may be brought under the same control.

2. To the common control may be added a common financial structure by which all future financing of operations may be handled through the holding company. The public will be invited to buy securities of the holding company only, which, in turn, will finance the subsidiaries.

3. Through the use of a liberal portion of bonds and nonvoting stocks in the hands of the public, the holding company facilitates concentration of control of voting stock with a minimum of investment.

4. The second purpose stated above may lead to capital inflation through the sale to the public of an amount of stocks and bonds of the holding company in excess of the aggregate of investment in the subsidiaries. The original owners of the securities of the subsidiaries may thereby make a handsome financing profit and still retain control through ownership of voting stock.

The earliest holding companies in the field of public utilities were organized, around the beginning of the present century, to attempt to solve the financial, technical, and management problems of the operating companies. The flood of public utility holding companies organized in the decade of the 1920's was the result of the speculative fever of the time. Bankers and not operators were their sponsors. The pattern was superficially similar to that used in the earlier period, but the results were strikingly different.<sup>1</sup>

Since the financing operations of holding companies have been dramatized in the attacks made upon them, an illustration of holding company finance will show how ease of control is effected with a minimum of investment. Suppose that corporation *A* is financed as follows: bonds, \$500,000; preferred stock, nonvoting, \$200,000; common stock, \$300,000. Assume that corporation *B*, a holding company, is organized to own a 50 per cent interest in corporation *A*'s voting stock. That would require for corporation *B* a capitalization of \$150,000, which might easily be distributed as follows: bonds, \$50,000; preferred stock, \$50,000; and common stock, \$50,000. By this simple illustration, the ownership of slightly more than \$25,000, the majority interest in corporation *B*, could control \$1,000,000 of assets in corporation *A*. In the illustration used it is assumed that a 50 per cent interest in the voting common stock would afford control. Actually, if the other stock is in scattered ownerships, much less than a 50 per cent ownership of *B*'s common stock would control *A*'s assets and operating policies.

In a study made by the Federal Trade Commission and reported to the United States Senate in 1935,<sup>2</sup> the distribution of stocks and bonds for 18 top

<sup>1</sup>Buchanan, N. S., *The Origin and Development of the Public Utility Holding Company*, *Journal of Political Economy*, February, 1936, pp. 31-53.

<sup>2</sup>*Senate Document 92*, Part 72A, 70th Congress, 1st Session, pp. 315 ff.

holding companies, 42 intermediate holding companies, and 91 operating companies was as follows:

Kind of security	Percentage distribution		
	18 top holding companies	42 intermediate holding companies	91 operating companies
Common stock.....	49 4	51 2	29.4
Preferred stock.....	23.2	29 9	21.4
Funded debt.....	27 4	18.9	49 2
Total... ..	100.0	100.0	100.0

**Advantages of the Holding Company.**—The holding company device is an alternative to each of the other forms of combination. The advantages claimed for the holding company include the following:

1. Ease in organization appears to be the outstanding advantage. Without consulting the stockholders of either the holding company or the corporation whose stock is to be purchased, the managers of the former may quietly acquire the amount of stock required for control. Recalcitrant minorities may continue as such. None of their rights as minorities are denied them, yet their power is limited to their voting strength. Bonded indebtedness containing embarrassing after-acquired property clauses constitutes no hindrance to holding company financing.

2. Hindering legislation against the operations of foreign corporations can be overcome through the organization of domestic subsidiaries. For example, in those states whose legislation places obstacles in the path of operations by corporations domiciled in another state, it is easy to form a subsidiary corporation to operate within the state in question. By holding its stock, the foreign corporation may still determine its policies.

3. Control of the whole enterprise can easily be perpetuated in the hands of the organizers by retaining for them merely a controlling interest in the voting stock. Not only control but the opportunity to trade on the equity in a highly concentrated form is afforded by the use of the holding company device. Leverage may give the owners of the voting stock a tremendous advantage where bonds and preferred stock are used in the financial plans of the holding company and its subsidiaries. Then too the control permitted by the use of holding companies may be used to the advantage of those who exercise it in ways other than the receipt of dividends.

4. If the purpose clause of a corporate charter is somewhat narrow, a subsidiary may be organized to perform functions not contemplated in the charter of the parent or holding company. Indeed some of the things the corporation might wish to do could be distinctly *ultra vires*. If it is per-

mitted to organize a separate subsidiary, the purpose clause of the new corporation can be whatever the parent company wishes it to be, within the limits permitted by the chartering authority.

5. From time to time, a corporation may find advantage in keeping ownership of certain business operations secret. A separate incorporation of a subsidiary facilitates this process.

6. Akin to the last advantage is the possibility of having a separate corporation conduct experiments that might prove unsuccessful and result in damage to the reputation and credit of the parent company, should it assume direct responsibility for the experiments.

7. There may be economy in quiet purchase of stock of a company in the open market. If the desire of company *A* to acquire company *B* became known, prices of the stock of company *B* would mount. Quiet purchase of stock may enable the purchasing company to acquire control before publicity is given to the identity of the purchaser.

8. Through the use of collateral trust bonds, secured by the stock purchased or to be purchased, control of an existing company may be acquired by the holding company with little or no outlay of cash.

9. Centralization of control may be accompanied by decentralization of operations under the holding company plan. Separate staffs, separate accounting records, and separate responsibilities for results may produce increased operating efficiency.

10. Where monopoly is intended, fighting subsidiaries may be organized to break the power of competitors. The subsidiary may sell its products at a loss as long as necessary to sap the strength of the competitor.

11. Maintenance of separate corporate existences by subsidiaries has been recognized by courts as a sufficient protection against creditors whose claims exceed the ability of the company which owes them. The creditors can look only to the subsidiary that incurs the debt but may not seek redress from the parent or holding company or from other subsidiaries in the system.

12. Subsidiaries are used to enable employees and others to acquire the securities of the parent company. When the market is favorable, the subsidiary may acquire the parent company's stock which is then sold to key executives and perhaps to other employees as well. The General Motors Corp. has made free use of this means of encouraging its younger executives to acquire a proprietary interest in its affairs.

13. Not only are subsidiaries useful in handling the affairs of a corporation in states other than the one in which the parent company is domiciled, but they are equally useful in handling foreign business. Tariff restrictions and governmental opposition of various sorts may be overcome by this means. Local capital and support may be enlisted without loss of control. Many operating American corporations have owned controlling interests in their subsidiaries located in foreign countries. Such ownership may prove

embarrassing in times of war, when properties are seized by foreign governments. Both in the First World War and the Second World War the losses to American corporations from this source were tremendous. Some pure holding companies merely acquire speculative interests in the stocks of corporations operating in other countries. The Associated Rayon Corp. was organized in 1928 to acquire securities of domestic and foreign companies operating in the rayon and allied fields. At the time of its dissolution in 1936, it held stocks in corporations organized in the United States, Germany, Austria, Italy, Japan, and the Netherlands.

14. Mistakes in property acquisition are easily corrected if such property is owned by a subsidiary. If railroad "feeders" prove to be "suckers," the stock of the subsidiary can be disposed of. Industrial white elephants can be abandoned, if necessary, by the dissolution of the subsidiary that owns them. In the same manner, property no longer useful or operations unprofitable to the corporation can be turned over to a subsidiary for liquidation.

15. Subsidiaries may be formed to handle specific parts of business operation such as sales, advertising, insurance, finance, and even production of parts.

For example, the Standard Oil Co. of California formed the Standard Stations, Inc., with stations in California, Washington, Oregon, Arizona, and New Mexico.

16. Joint use by several companies of a specialized property, such as a railroad terminal building, can be facilitated through the holding company device.

17. Disputed property rights, such as overlapping patents, may be settled by turning them all over to a separate corporation, the ownership of which is divided among the various claimants according to agreement.

**Disadvantages.**—Even the champions of the holding company device admit that it has weaknesses that are not always easily corrected. Among the outstanding disadvantages are the following:

1. The holding company affords control only and does not always effect complete integration. Consequently, care must be exercised to protect the rights of creditors and minority stockholders.

2. The tax burdens against the various corporations in a holding company system may at times result in merging the companies into a single corporate unit. The Greyhound Corp. found the tax burdens of operating its various lines under separate corporate entities sufficiently burdensome to induce their elimination through merger. Incidentally, it simplified its accounting procedure and reduced its legal expenses as well. The absorption by the Atlas Securities Corp. of the Pacific Eastern Corp., the Shenandoah Corp., and the Sterling Corp. permitted all earnings of these various companies to accrue directly to the Atlas Corp. without intervening tax payments. Concurrently, problems of management were simplified and duplications of corporate



expenses were eliminated. Sometimes, however, minority interests and other obstacles prevent such mergers.

3. The invitation to financial inflation may result in burdensome fixed charges in times of adversity. A top-heavy financial structure, created in times of prosperity, may collapse in succeeding depression periods.

4. The ease of controlling all property and operations in the system through the ownership of a small part of the total investment leads at times to manipulation of accounts and security prices by those in control to the disadvantage of creditors and owners of nonvoting securities.

5. Maintenance of separate corporate existences for the various subsidiaries involves some expense.

6. Decentralization of administration may not always produce the desired results.

7. Dissolution may not always be only at the request of the holding company management. Wherever financial difficulties are encountered, some subsidiaries may be separated from the system by foreclosure against their properties, in spite of the desires of management to keep them. Anti-trust proceedings may also result in dissolution.

8. Excessive charges by the holding company against its operating-company subsidiaries for management services, construction, or equipment is not in the interest of the public which buys its services.

**The Holding Company a Preliminary to Merger.**—As already suggested, the purchase of stock of a corporation may be accomplished quietly, until enough is secured to give control to the holding company. Thereafter, additional stock may be acquired from time to time, until all is owned by the holding company. Then, if desirable, the separate existence of the subsidiary may be terminated, and it may be merged into the parent company. Final minorities may gain considerable advantage from their bargaining position, if they realize the desire of the parent to terminate the corporate existence of the subsidiary and bargain shrewdly in the sale of their stock.

**Financing Companies.**—Some holding companies in the public utility field, for instance, are formed for the purpose of financing equipment sold by manufacturers to small utility operating companies. Such financing companies, owned by the equipment companies, exchange equipment for stocks, bonds, or notes of the utility that purchases the equipment. These stocks, bonds, and/or notes are then used by the financing company as collateral for their own bonds which are sold to the investing public. This practice keeps the accounts of the manufacturing company liquid and enables the purchasing utilities to acquire equipment that they could not otherwise finance.

**Management Companies.**—Akin to the holding companies are so-called "management companies," which own less than a controlling interest in the corporations they serve. Such companies render expert services in the

nature of engineering and financial advice, for which they receive a fee, sometimes paid in the securities of the corporations served. At times, the services extend to direct supervision of operations instead of being restricted merely to the giving of advice.

**Services by Holding Companies.**—The holding companies themselves may render the services sometimes performed by financing and management companies. The extent of services rendered by the holding companies varies with the industry and may cover a wide range of activities. A list of possible services is suggestive.

1. Supervision of operations by a staff of experts.
2. Community purchasing for all subsidiaries.
3. Expert legal services in drawing contracts, mortgages, and other documents and in meeting requirements of blue-sky laws and other regulatory policies.
4. Accounting services in auditing reports, preparing tax returns, and other reports.
5. Engineering services of various kinds.
6. Handling of security records, dividends, and notices to stockholders.
7. Construction of new facilities.

The principal sources of revenue of the Electric Bond and Share Co. are (1) dividends and interest on securities owned; (2) payment for financial services rendered associated companies, including the marketing of their securities; (3) payment for planning and construction of properties for associated companies; (4) consolidations and reorganizations; (5) interest on loans and bank balances; (6) profits from dealing in securities. The company has six associated holding companies.

**Financing Services.**—The holding company is especially useful to its subsidiaries in the field of finance. The services in this field are chiefly three in number:

1. The holding company may market the securities of the subsidiary for any or all of the purposes for which the subsidiary would need new capital. The wider reputation of the holding company in itself would be of use to the subsidiary, whose independent credit and reputation might not be extensive.
2. As an alternative, the holding company may use the stocks and bonds of its subsidiaries as the security for its own issues, sell the latter in the open market, and use the proceeds to finance construction, expansion, or refunding operations of its subsidiaries.
3. Temporary operating expenses or even capital expenditures of subsidiary companies may be financed by advances from holding companies. The receipts from prosperous subsidiaries may be used to finance the operations of weak subsidiaries in times of stress. It is not always easy to determine from balance sheets whether advances to subsidiaries cover operating losses or construction to be capitalized at a later time.

**Industrial Holding Companies.**—Judicial decisions against holding companies, coupled with the clause in the Clayton Act of 1914 against their use in interstate commerce, tended to discourage their use where they might be attacked for effecting unreasonable restraint of trade. In the combination period following the First World War, this form of combination was revived, particularly where noncompeting corporations were brought together into circular combinations. Some of these used the holding company device as a step toward merger or consolidation, while others retained the holding company form.

However, since the Clayton Act was not *ex post facto* in character, the holding and parent companies in existence at the time of its enactment were not affected directly. As a consequence of the large number that were organized previous to 1914, many are still in existence. Others that appear not to be in violation of the Clayton Act have been organized since its passage. It should be noted that, as a general rule, holding companies organized in the industrial field have placed greater emphasis upon operating programs than upon financial manipulation so common in the public utility field. Pyramiding of holding companies, so common among public utilities, is not so often practiced among industrial holding companies.

**Bank Holding Company.**—Because of the restrictions against branch banking in the United States, the holding company device has recently been adopted to effect the purposes served by branch banking. Since the holding company is not a banking corporation and hence not subject to regulation by banking departments of state and national governments, its use raised some interesting legal questions, among which was the possible evasion of double liability for bank stock. Most of the questions raised by the recent development of bank holding companies have not yet been finally adjudicated.

**Public Utility Holding Companies.**—Holding companies have had most extended development in the field of public utilities. Local transportation companies have not attracted the attention of financiers because, for some years, they have been on the decline. A few large companies control approximately half the distribution of gas. Less than a dozen holding company systems control about three-fourths of the electric-light and -power business. One large system controls nearly all the telephone business of the entire country. The two most important reasons for the dominance of the holding company in the public utility industries are (1) the great financial strength of the holding company in comparison with most independent operating companies, and (2) the higher efficiency of the centralized management in a stabilized field. Both these advantages have been capitalized by promoters of public utility holding companies. Consequently, the public has not always enjoyed lower costs for services that might have resulted had the holding companies been subjected to the same sort of regulation as that meted out to operating companies.

One interesting characteristic of public utility control by holding company systems is the complexity of their organization. Between the operating company and the dominant holding company, there may be many intervening corporations. Some of these are pure holding companies, and some are parent operating companies. They result, in part, from the combinations of combinations in recent years and, in part, from the studied effort to evade regulation by public-service commissions.

**Pyramiding of Control.**—Concentration has been carried much further in the public utility industries than in any other field. Various devices have been used to accomplish this purpose, including large bond issues against operating properties, following by large preferred-stock issues carrying no voting rights, or only contingent control; these, in turn, are followed by classified common stock, only a part of which has voting rights. In addition, voting trusts, giving to a small group of trustees complete control for a definite period of time, have been resorted to. Where the management has had only minority ownership of voting stock, its continued control has often been assured by the possession of enough stock purchase warrants to give it majority control if needed. Some holding company charters have contained provisions waiving preemptive rights of existing stockholders to the purchase of new issues of stock. This device makes possible the issue of new stock to a favored few, if their control is threatened. When to these devices intended to ensure continuance of control is added the wide distribution of shares, it is easy to understand how a small minority of voting stock can control large aggregates of assets.<sup>1</sup>

**Speculation.**—The pyramiding of securities of public utility holding companies has induced a high degree of speculation in the securities representing residual equities. Because of this pyramiding of securities, a small increase in net income of operating companies may result in a tremendous increase in the earnings per share of holding companies. Purchasers of such stock think in terms of public utilities as stable industries, having monopolistic control over their fields. Without studying the financial setups of the corporations whose stock they buy, they are apt to be misled by reported increases in earnings. At the other end of the business cycle, a slight drop in earnings of the operating companies may result in a corresponding tremendous decrease in earnings per share of the stock of the holding company.

By using bonds, preferred stock, and common stock in the financial plans of operating companies and holding companies of various kinds, it is easy to see how reasonably good net earnings of the operating companies would become very high rates of earnings on the common stocks of the top holding companies. By the time trading on the equity has been carried through a half dozen layers of holding companies, the resulting net earnings for the top

<sup>1</sup> Bonbright and Means, *op. cit.*, p. 147.

holding company stock could easily become very large indeed. On the other hand, if the earnings of the operating companies should drop even moderately, the presence of bond interest obligations in each of the holding companies might easily cause the complete collapse of the entire holding company system through inability to meet fixed charges.

Even where the net income of operating companies was well maintained, many ventures into the field of public utility holding company speculation failed to produce satisfactory final results. The banker promoters lost their sense of proportion in their search for financing profits. Their interest was centered upon the boiling stock market of the 1920's. It seemed that the stock-hungry public was willing and anxious to buy any kind of a security that promised to go up in price. Promoters scoured the country to find new opportunities for combinations that would in turn call for the issuance of more securities. The public utility industry offered promising opportunities for combinations.

The prices paid for the companies that formed the great holding company systems were not always set in terms of their long-run earning capacities but in terms of the short-time ability of the promoters to sell securities against them in sufficient quantities to recover a profit. Bidding for these utilities produced prices that were out of line with earning capacities, even under favorable circumstances. Since there were not enough real public utility properties to satisfy the demand, some industries were tapped to find properties for inclusion in holding company systems that could hardly be classed as public utility industries. This did not deter an indiscriminating public from buying the securities offered. Neither did geographical dispersion of properties interfere with their assembly for financing purposes. Since a financing profit was the goal of the promoters, what did it matter that a water company in New England was combined in the same system with a street railway in the Middle West and an electric light company in the South? Not operating consistency but the ability of the promoters to convince the security-buying public of the profit possibilities in the purchase of stocks and bonds dictated the composition of holding company systems.

**Holding Company Abuses.**—Had holding companies adhered to the principles upon which they were founded, it is not likely that there would have been raised the hue and cry against them which culminated in the passage of the death sentence law. The opportunities for a financial profit out of proportion to the services rendered in return for it apparently were too great not to attract practices that produced abuses in the application of the holding company principle. Among the most flagrant abuses are the following:

1. *Milking of Subsidiaries.*—A holding company buys the common stock of a well-managed company that has outstanding senior securities equal to a large proportion of its assets. Or, if there are no large issues of bonds and senior stock outstanding, it is easy for the holding company to market them

for a successful subsidiary. Thereafter, the milking process is applied quite scientifically. The surplus of the subsidiary is siphoned into the treasury of the holding company by means of large cash dividends, stock distributions, and rights. Exorbitant charges for accounting, engineering, legal, management, and technical services supposedly rendered by the holding company drain the resources of the subsidiary. Padded expense accounts and increased salaries for officers, intercorporate contracts disadvantageous to the subsidiary, and the use of construction and purchase companies accomplish the same purpose. If books of account are manipulated meantime, all this may be accomplished in a manner that is more real than apparent.

At the conclusion of the milking process, the holding company may dispose of its stake in the shell of the subsidiary by the sale of its holdings to outsiders. Investors and speculators who give attention only to its past record may be properly impressed with the opportunity afforded them. Whether such holdings are disposed of or not, the milking process is accomplished at the expense of the creditors, preferred stockholders, and consumers of the subsidiary's products.

2. *Policy Control.*—Whether the holding company goes so far as to milk the subsidiary, it is at least in a favorable position so to direct its affairs as to benefit itself to the utmost degree. Under the cloak of intercorporate control is frequently hidden the dagger of selfish interests that dictate subsidiary production, price, sales, and credit policies in the interests of the parent company. In this operation, the individual interests of holding company officials are not overlooked.

3. *Security Manipulation.*—The fortunes of the holding company and its subsidiaries are so interlocked—or may be so directed—as to invite manipulation of the security prices of the holding company, the subsidiaries, or both, by those in a position to attract or repel investors in such securities. Indeed, the profit possibilities in such manipulation have been the greatest magnet to draw the attention of financiers to some holding company operations. Few question the ethics of inside speculation in the securities of either the holding company or its subsidiaries. When such speculation is within the control of those whose profit possibilities are greatest, its extent begins to shed light on the reasons for its practice. A glance behind the curtains explains the presence of a financing profit from the sale to the public of more bonds against the assets of a subsidiary than the entire investment of a holding company in them. Again, manipulation of accounts does no harm to the plans of the security manipulators.

4. *Taxation Evasion.*—Nowhere in the realm of business has the race between the tax collector and the official corporate family been hotter than in the field of holding companies. The latter accuses the former of multiple taxation. In defense of this position, it must be admitted that a revenue law that taxes corporate income gets several bites of the same dollar if it

passes from one corporation to another as income. If, on the other hand, the profits of one member of the holding company family are absorbed by the losses of another member, the story sounds quite different. While tax evasion is not confined to either corporations or holding companies, the latter are not immune to its practice.

**Speculative Companies in the Depression.**—In spite of what is said above about speculative holding company systems in the field of public utilities, the number of holding company failures in the depression following the 1929 crash was surprisingly small. A few spectacular ones showed how the holding company principle had been distorted in such manner that an aroused public demanded that something be done about it. The most spectacular crash came in the Insull empire. What Rockefeller was to the industrial combination movement of the late 1880's, Insull was to the public utility holding company movement of the 1920's. While their methods and their objectives were different, the public looked upon each as the creator of a system that should be abolished.

In the Insull system, it was not uncommon to have as many as seven layers of holding companies superimposed upon the operating companies at the base of the pyramid. The Federal Trade Commission found that equities were spread so thin in the pyramiding of these companies that \$1 invested in the stock of the top holding company controlled as much as \$2,000 in the assets of the operating companies. With such an inflated financial plan, there is little wonder that this system collapsed completely in the years following the crash of 1929. Other speculative systems, less well publicized, also found it impossible to meet their fixed charges and were forced to reorganize in the decade of the 1930's. A second group of public utility holding companies, covering a larger segment of the industry, were able to meet their fixed charges but found it necessary to permit preferred dividends to accumulate to a total of hundreds of millions of dollars during the depression. Some of these dividends accumulated on the stocks of intermediate and top holding companies, while others accumulated on operating company stocks. In either case, too liberal financing was indicated.

**Background of Public Utility Holding Company Act.**—Most public utility operating companies are supposed to be intrastate in character. A street railway company serves one community. A gas company distributes its product in a closely knit urban area. Yet for years local and even state public utility regulatory agencies have found themselves powerless to deal adequately with the intercorporate relations that surround many regulatory problems. For example, the gas that is consumed in Columbus, Ohio, is distributed by one corporation of a holding company system which buys its gas from another corporation in the same system but which may not be classed as a public utility, or at least may not be subject to the same kind of regulation as the distributing system. The gas may be taken from wells in

West Virginia or in Texas where the cost of production is entirely outside the control of the regulatory authorities of the State of Ohio. Even electric power is transmitted across state lines. In other words, to an increasing extent the public utility business transcends urban and even state boundaries. It is easy to see, therefore, the futility of attempts to apply local or even state regulation to such businesses.

The need for calling upon the Federal government to assist in the regulation of public utilities has been felt for some time. Proposals for legislation to bring this about had been successfully opposed up to the decade of the 1930's. The dramatization of holding company abuses and the effects of the financial excesses of the 1920's were sufficient to permit the New Deal economists to overcome this opposition in the passage of the Public Utility Holding Company Act of 1935. While this law is not primarily concerned with the regulation of the public utility industry in all its ramifications, its enforcement as written is bound to have an influence upon regulation by other agencies.

**Provisions of the Act.**—The act provides for the registration with the Securities and Exchange Commission of all public utility holding companies doing an interstate business in electricity or gas. A holding company as defined in the law is one having at least 10 per cent of voting control of another company. At first many holding companies refused to register on the ground that the act was unconstitutional. This point was clarified by the Supreme Court in March, 1938, when it ruled against the Electric Bond and Share Co. which, up to that time, had refused to register. In registering with the commission, each holding company must give detailed information about its plan of organization, its financial plan, and the control over its policies. The commission is given a considerable amount of discretionary power to rebuild holding company systems and to control their financing.

**Death Sentence.**—One of the outstanding features of the act deals with the subject of disintegration or integration of systems, depending upon the point of view of the person who looks at it. Friends of the law think in terms of confining holding company operations within reasonable bounds. Enemies think of this section of the act as the "death sentence" for public utility holding companies. Some have given the name "Death Sentence Act" to the law. Opponents of the law have emphasized the diversification feature of existing holding companies as an advantage to the investor in their securities. In this connection, most of the discussions tend to give lip service to the principle of diversification, without offering any evidence to prove that the kind of diversification that has been practiced has resulted in stable values for public utility holding company securities.

At any rate, the law requires the commission to study the interrelation-



ships within each registered holding company and after Jan. 1, 1938, to simplify each system in such manner as to eliminate much of the hierarchy of holding companies and at the same time to effect more logical geographical concentration of operations. Specifically, the commission is empowered to insist that each holding company be broken up into well-integrated parts or systems. As applied to electric companies, for example, the law requires the separation of systems in such manner that the resulting

utility assets, whether owned by one or more electric utility companies, are physically interconnected or capable of physical interconnection and which under normal conditions may be economically operated as a single interconnected and coordinated system confined in its operations to a single area or region, in one or more states, not so large as to impair . . . the advantages of localized management, efficient operation, and the effectiveness of regulation.

To get rid of the many-layered holding companies, the commission may approve of a three-layer system, consisting of operating companies, intermediate holding companies, and a top holding company. No subsidiary may be acquired without the approval of the commission.

**Methods of Compliance.**—The following alternative methods appear to be available to widely diversified holding companies: (1) Exchanges of properties may be effected among different systems to produce better integrated systems which can be more simply financed. This may necessitate exchange of securities. (2) New holding companies, each to control a single integrated system, may be created. Similar plans have been followed in the disintegration of industrial combinations dissolved under the antitrust acts. (3) Securities held by a holding company may be distributed to the holders of its own shares. This would involve some preliminary refinancing in many cases, but again there is precedent for this method of compliance with the law. (4) The act permits the continuance of ownership of securities by existing holding companies, provided they become investment trusts and abandon control over the companies whose securities they own. Distribution of common shares from time to time and enfranchisement of preferred shares would probably be favored by the commission.

In the disintegrating process, it is to be hoped that steps will not be taken that will either leave operating units adrift without adequate provision for operating efficiency or will make impossible the retention for the industry of the beneficial results of operating economies that integration permits. The problem before the commission is to formulate plans that will preserve the good and eliminate the evil in holding companies. The transition period may produce the usual effects that accompany any major operation.

**Registrations.**—As of June 30, 1945, there were registered under this law 54 public utility holding company systems, consisting of 118 registered

holding companies and 943 electric, gas, and nonutility subsidiaries. The aggregate consolidated assets amounted to \$16,200,000,000. Acting under the law described above, 146 plans had been filed with the commission as of June 30, 1945. The commission approved 56, frequently after modifying them; 23 were withdrawn; 3 were denied; and 64 were pending as of the above date. In the plans approved, 342 electric, gas, and other subsidiaries, with assets of \$4,347,000,000, were divested by registered holding companies; 51 companies with total assets of \$293,280,924 were sold to municipalities, public authorities, rural cooperatives, and the T.V.A.; 291 companies, with assets of \$4,053,719,000, were continued under private ownership. Most of the outstanding cases are still pending.

**Regulation of Finances.**—With respect to control over the financing of public utility holding companies, the commission is endowed with much broader powers than were conferred upon it by the Securities Act of 1933. The latter depends upon publicity without giving the commission much discretion to prevent the issuance of any specific securities if all sections of the law are adhered to. In the Holding Company Act, the commission is granted the authority to approve the securities to be issued by public utility holding companies and their subsidiaries. Without the specific approval of the commission, the following kinds of securities may not be used: no-par stock, nonvoting stock, preferred stock, and unsecured bonds. The law leans in the direction of simple financial plans, using only common stock and secured bonds.

In passing judgment upon a proposed security issue, the commission must make sure that the charges necessitated by the issue, if any, shall bear a proper relationship to the probable earning power of the issuer; that the funds to be raised by the sale of the securities are necessary and appropriate to the economical and efficient operation of the business; and that the new issue bears a proper relationship to the outstanding securities of the issuer and of the other companies in the same holding company system. All details of the issuance of the securities are left to the discretion of the commission except such as are fixed by the law. The latter forbids house-to-house selling and sale through any officer or employee of a subsidiary company. In granting permission for the issuance of securities, the commission may impose such conditions as it sees fit.

**Other Powers.**—Among the other powers to regulate public utility companies, the commission is given control over various intercompany transactions, *i.e.*, loans, security sales, and contracts involving construction, sales, service, and managerial arrangements. On the latter subject, it is evident that the law intends to try to eliminate absentee control. To this end, various restrictions are placed upon those who determine the policies of the systems. The law prohibits "upstream financing"—borrowing by a holding

company from a subsidiary. All officers and directors must keep on file with the commission a current record of their security holdings within the system. They must not be officials of investment banking firms. Politically they are prohibited from making contributions and all appearances before Congressional committees must be registered with the commission.

The commission is authorized by the act to require periodic reports from all registered companies. To make sure that these reports shall give the commission the information in the form desired, it is empowered to prescribe accounting procedures and the means of keeping records. In addition, the commission is authorized to make studies of the entire public utility industry and to make to Congress such recommendations as it thinks would be in the interest of the public, the investor, and the consumer.

**Electric Bond and Share Co.**—The largest of the holding companies systems registered under the act was the Electric Bond and Share Co., with total assets of approximately \$3½ billion, with 5 intermediate holding companies, and 237 subsidiaries. In 1941, the commission ordered the dissolution of the National Power and Light Co., one of the major intermediate holding companies. In August, 1942, it ordered the dissolution of two more, the American Power and Light Co. and the Electric Power and Light Corp. The following quotation from the *Wall Street Journal* of Aug. 26, 1942, indicates the reasoning of the commission in ordering the dissolutions:

Summarizing its conclusions as to the lack of function for American and Electric, the Commission stated: "It is indisputable that American and Electric are not only undue complexities but are wholly unnecessary ones, inasmuch as there is not now, nor has there ever been, reason or purpose for their existence except as instrumentalities through which Bond and Share is able to control their systems by a pyramiding arrangement wholly repugnant to the statute. Neither for their subsidiaries nor for their own investors do these subholding companies perform, or have they ever performed, any useful function; indeed for the latter, they entail unnecessary expense and serious complications from an investment point of view. It is to be noted, furthermore, that the increased taxes and operating costs which must be borne by the subholding companies and their subsidiaries by reason of the present war will necessarily aggravate the financial difficulties of American and Electric, and render their continued existence even more burdensome to their subsidiaries and security holders."

Summarizing the outcome of the formation of American, the Commission stated in its finding and opinion: "It is thus apparent that Bond and Share had succeeded in realizing for itself complete working control of the new company and better than a 20% equity in it, after recovering every dollar of its investment in the securities transferred to American, plus a cash profit of approximately \$120,000. Otherwise stated, Bond and Share had sold out an 80% interest in the aforementioned securities, recovering thereby its entire cost plus a substantial profit without in

any way parting with control of such securities or of the properties which they represented."

The Commission indicated that the formation of Electric Power and Light in 1925 proved to be an even more profitable venture for Bond and Share. It stated: "The outcome for Bond and Share of the organization and financing of Electric was successful beyond all previous ventures—not only did Bond and Share acquire its entire initial common stock investment in Electric at a cost of approximately 'minus' \$6,500,000, but in customary fashion it also emerged with complete control of the new company."

The Commission's findings explained that E.B.&S. and its subholding companies were able to realize these substantial profits principally through proficient use of the "write-up" technique.

**Under the Curse.**—Because of the abuses to which holding company operations have been subjected in recent years, the whole principle has been placed under the spotlight of adverse publicity. Will the principle be sacrificed because it has been abused? Can the advantages of the holding company plan be preserved in other forms if the existing form is completely abolished? These are questions for future determination. Just at present, the curse is upon the holding company.

It is too early to determine or even to predict accurately the effects of this act, assuming that it is not seriously modified and that it is administered as planned. Presumably those holding companies that are predominantly intrastate in their scope would be little affected. Also closely knit, simply financed, and well-managed systems will probably not be seriously hampered in their plans. Various alternatives are open to complicated holding companies whose operations cover a wide geographical area.

A few facts seem self-evident. Now that the abuses of holding companies have been brought into sharp relief through various governmental investigations, culminating in the passage of a law that covers one section of the field quite thoroughly, it is not likely that there will be any retreat in this area at least. Instead, it is probable that the unwieldy public utility holding company systems will be reduced to manageable size and consistency. It is unlikely that there will be a repetition of the excesses that characterized the sprawling systems built up by Insull, for example. Also it appears that fear of action by the commission will cause continued changes in the direction of simplification of corporate plans and procedures without waiting for compulsion in the form of orders from the commission.

What cannot be foretold at this time is the probability of extension into other fields of the principles that have been adopted for the regulation of public utility holding companies. Also it is well known that bureaucracies are never content with the power and authority that is granted them. They are constantly pressing legislative bodies for the grant of additional powers.

Already there are raised some interesting questions about the division of authority existing under the present law between operators and regulators. The line between regulation of a business and operating responsibility is a shifting one. As has been stated elsewhere in this volume, we dare not transfer too much authority from the management to the regulators unless we plan to hold the latter responsible for the results.

### QUESTIONS AND SUGGESTIONS

1. What is the public attitude toward holding companies? Why? What kinds of holding companies are used?
2. How much stock of an operating company must a holding company own in order to control it?
3. How can minority and creditor interests be protected against unfair actions of holding companies?
4. Where does a corporation obtain the right to hold stock in another corporation?
5. What has been the experience of holding company legislation in New Jersey? Why?
6. What are the purposes of holding companies?
7. How do the financial plans of top holding companies compare with those of operating companies?
8. What are the advantages and the disadvantages of holding companies?
9. In what way may the holding company be used as a preliminary to a merger?
10. What kinds of service may a holding company render to its subsidiaries? What kinds of financial service are so rendered?
11. Did the Clayton Act abolish holding companies? Explain.
12. In what fields of business operation have holding companies been most commonly used? Why? Why have they been so commonly used in the public utility industry?
13. Give an example of pyramiding of control by the use of holding companies.
14. How has the holding company device aided speculation?
15. What kinds of holding company abuses have been practiced?
16. What is the background of the Public Utility Holding Company Act? Summarize its important provisions. Why has it been called the Death Sentence Act?
17. How may holding companies comply with this law?
18. How does the Securities and Exchange Commission regulate the finances of holding companies?
19. How successful has the commission been in breaking up holding company systems?

### SUPPLEMENTARY READINGS

- BONBRIGHT, J. C., and G. C. MEANS: "The Holding Company" (New York: McGraw-Hill Book Company, Inc., 1932).
- CRUMBAKER, C.: "Organizing and Financing Modern Business" (New York: John Wiley & Sons, Inc., 1939), Chap. V.
- DEWING, A. S.: "Financial Policy of Corporations" (New York: The Ronald Press Company, 1941), Book IV, Chap. VI.
- DONALDSON, E. F.: "Business Organization and Procedure" (New York: McGraw-Hill Book Company, Inc., 1938), Chap. XXXVIII.
- HUSBAND, W. H., and J. C. DOCKERY: "Modern Corporation Finance" (Chicago: Richard D. Irwin, Inc., 1942), Chap. XXXII.

- LINCOLN, E. E.: "Applied Business Finance" (New York: McGraw-Hill Book Company, Inc., 1941), Chap. IV.
- OWENS, R. N.: "Business Organization and Combination" (New York: Prentice-Hall, Inc., 1940), Chap. XXI.

### SUBJECTS FOR INVESTIGATION

1. From the *Commercial and Financial Chronicle* or from a recent manual, find two pure holding companies. Why do you classify them as such?
2. From the same source find two parent companies, and tell why you classify them as such.
3. From the reports of the Securities and Exchange Commission, show what has happened to a specific public utility holding company system.

## CHAPTER XXXVII

### RAILROAD EXPANSION

**Significance.**—Up to the time of the Second World War, there was considerable evidence to support the claims that American railroads were passing through a declining period as effective agents of transportation and as an industry to which stock- and bondholders could look for sound investments. The competition of trucks, busses, privately owned automobiles and airplanes had combined to take from the railroads much of the traffic that they formerly enjoyed. Financially, the railroad business appeared to be headed for permanent trouble. As a matter of fact, throughout the hectic decade of the 1920's, railroads had surrendered their position of market leadership to industrial and public utility corporations. The mysteries surrounding the latter afforded better soil for the growing of rumors than did the known facts of the former.

Yet railroad finance is still significant from at least two points of view. Historically, much of the financial development that has characterized other industries was first tried out in the financing of railroads. Statistically, the amount invested in American railroads is still very large. According to a study made by the United States Department of Commerce, the book values of the road and equipment of Class I roads (gross revenues for each \$1,000,000 or more annually) amounted in 1937 to \$22,600,000,000, against which the outstanding bonds and stocks had a par value of \$18,300,000,000.<sup>1</sup> The further significance of railroad finance lies in the fact that approximately half of the railroad bonds outstanding are owned by insurance companies and banks and that the remainder and the stocks are scattered among many small investors and speculators. The railroads still employ more than a million persons, and American shippers and passengers are still dependent upon them for transportation service, in spite of their continued decline in popularity for more than a generation.

**Railroad Financial Plans.**—The financial plans of the earliest American railroad companies was quite simple, consisting chiefly of stock. Very soon, however, bonds were introduced, first short-term and then longer as the railroad net developed. With the beginnings of the railroad consolidations, early simple financial plans gave way to those with more and more complexity until the pattern of stocks and bonds became so confused that even

<sup>1</sup> "Long Term Debts in the United States," U.S. Department of Commerce (Washington, 1937), p. 52.

experts in finance have difficulty in keeping relationships straight. Meantime, had the plans of some of the railroad managers worked out as contemplated, these complex plans would have become simplified again as small bond issues were absorbed into large blanket issues, some of which in turn were convertible into stock. Hence it may be said that the intended pattern of the more flexible railroad financial plans was from the simple to the complex to the simple again. For reasons that will be developed in this chapter, these plans have not materialized.

**Early Railroad Development.**—When railroads were first started in this country, no one visualized the vast network that has since been developed. At first they were merely rail roads—roads made more passable by any type of vehicle by the use of crude strap-iron rails. The motive power and the specialized rolling stock received less attention at the outset than the right of way. Indeed, at the outset, some companies set aside certain hours of the day for renting their right of way to shippers who furnished their own equipment. This plan soon proved its impracticability and was abandoned. The first railroads were local in character and were not thought of as the first links in an extensive transportation chain. Some of them were built as feeders to water lines. In a sense, some early railroads were in the nature of community-betterment institutions. They were looked upon as an important means to give to their terminal cities distinct economic advantages. For example, the Baltimore and Ohio Railroad was closely linked with the ambitions of the city of Baltimore, the Pennsylvania with Philadelphia, and the Erie with New York City.

To aid the development of railroads, all sorts of subsidy plans were tried. Land for rights of way, materials for construction, and cash were donated. Local municipal bonds that could be sold readily for cash were exchanged for railroad securities that lacked a ready market. States purchased railroad securities and made donations to prospective railroad corporations. Charters were granted freely to all comers. Federal aid took the form of liberal land grants and, in a few instances, of loans to railroad corporations. Land grants alone exceeded 150,000,000 acres. While this total represents an enormous acreage, it must be kept in mind that the grants were made at a time when it was thought that the available public lands of the United States were sufficient to meet all needs for hundreds of years. Also it should be remembered that these land grants provided the incentive for the construction of 21,500 miles of railroad, which in turn aided materially in the rapid development of the territory served.

**First Period of Consolidation.**—As stated above, the first railroads were local in character, built without particular attention to connections with other railroads. Indeed interchange of traffic among them would have been very difficult because of different gauges which prevented using cars over different rights of way and even because of adverse legislation which



frowned upon traffic interchanges, especially with railroads in another state. Gradually, however, it became apparent that the economical thing to do was to encourage what was known as end-to-end consolidations. By this is meant the fitting together of local railroads to form a connecting line between distant cities. This meant also filling in the gaps where roads had not yet been constructed. The first significant end-to-end consolidation resulted in the formation of the New York Central Railroad in 1853. It connected Buffalo in the West with Albany in the East.

The New York Central was followed by other end-to-end consolidations during the next twenty years, until by 1873 approximately 70 such through lines were completed. Meantime, railroad construction was proceeding along two other lines as well. Branch lines were being pushed into territories from which through lines hoped to receive much feeder traffic. And trunk lines were being started, irrespective of the process of end-to-end consolidation. This was particularly true of the Union Pacific and the Central Pacific railroads, fostered by the Congress of the United States as a war measure to tie California to the rest of the Union. The development of this program set the pattern for the construction of other transcontinental railroads which were to follow soon after the completion of the Union Pacific-Central Pacific venture.

**The Construction Company.**—An understanding of the financing of railroads in this country is not possible without at least brief reference to the use of the construction companies. They came into general use in the decade of the 1860's. With not only all citizens but government agencies as well anxious to push the building of railroads as rapidly as possible, it is not surprising that there should appear financial adventurers to take advantage of the promotional opportunities offered. The construction company was primarily a financing company. It contracted with the railroad company to build its line, accepting in payment blocks of railroad securities. Since European capital built many of the early railroads, bonds were needed to sell to those who put up the money. The initial capital of the construction companies was supplied by their promoters. The contract to build the railroad was farmed out to engineering firms. As soon as a section of the road was completed, the construction company received from the railroad company a block of bonds and stock. The bonds at least were sold to obtain the funds needed to construct the next section of the railroad.

It is not surprising that by this means railroads were built where there was little traffic to support them. Since even bonds were speculative in character, overcapitalization of these railroads, both in terms of earning power and in terms of actual cost of the properties, became very common. While it is easy to criticize the methods employed in financing the railroads built at the time the construction companies played such an important part, it is probable that such construction could not have been built otherwise.

While many railroads were built ahead of traffic demands, their presence permitted the rapid settlement of great areas that would have been inaccessible except for the railroads. In a real sense, the railroads developed their own traffic.

**Second Period of Consolidation.**—The overload of bonds not yet seasoned and not earning their fixed charges resulted in the railroad panic of 1873, with the reorganization of many companies to follow. Out of the reorganization procedures came a more extensive idea of consolidation. By this time the idea of the local nature of railroads had given way to the idea of connecting distant cities. After the panic of 1873, it became the fashion to combine even these longer lines into railroad systems with great networks of feeder branches. In spite of the sad experience of the panic of 1873, the mania for expansion had not spent itself and by 1893 the stage was set again for another railroad collapse. This was conditioned in part by legislation in most of the states which frowned upon the sale of railroad stock below par. Since par sales were not easy, the expansion of these two decades from 1873 to 1893 was financed in large part through the sale of additional bonds. And again failure to meet fixed charges resulted in reorganizations.

**Third Period of Consolidation.**—Following the emergence of railroads from receivership in the 1890's, a new figure with a new idea of consolidation appeared in the railroad world. The Drews and the Vanderbilts of the earlier periods had some idea of traffic consistency in piecing their systems together. There was more or less logic to the patterns that they followed. Under the leadership of E. H. Harriman, who was an unusual combination of operator and financier, systems began to be brought together under a single control in a manner that paralleled the contemporary industrial combinations. Railroad control became a battle of financial giants where the thirst for power rather than the logic of traffic consistency determined the composition of the supersystems that were built up. This period came to an abrupt end with the Northern Securities decision of 1904, which enunciated a policy of governmental disapproval of the methods employed in building up huge railroad consolidations.

From 1904 to the end of the First World War, there were no significant railroad consolidations. Further legislation and additional court decisions stamped the policy of the government as opposed to further company expansion. Meantime relatively little new construction had taken place within this period. Railroad managements were beginning to find that many branch lines that had been looked upon as feeders became suckers instead, unable to develop enough traffic to carry themselves. Hence they drew revenue away from main lines instead of adding to profits. As a consequence, the process of abandonment of branches and disintegration of systems as the result of reorganizations was experimented with in the period up to the end of the First World War.

**Financing of Consolidations.**—Before discussing recent railroad consolidation efforts and their financing, let us go back and review the financing of the consolidations of the first three periods. Almost always the small independent railroads that were pieced together to form through lines connecting major terminal cities had outstanding at the time of consolidation one or more mortgage bond issues which came to be known, after consolidation, as “underlying” issues. The combining company then issued bonds of its own, which were in the nature of junior liens, although they almost never used such names as second or third mortgage bonds. Instead they carried such titles as “first and general,” “general,” “first consolidated,” etc. When combinations were again combined into supercombinations, still other bond issues were superimposed upon the layers already outstanding when the consolidation was effected. Frequently each of these issues of “overlying” bonds contemplated the eventual absorption of all underlying issues, until only the one general bond issue was left outstanding. It was sometimes convertible into stock.

Several of the consolidations were effected by the use of collateral trust bonds. For example, when the Great Northern and the Northern Pacific acquired the stock of the Chicago, Burlington and Quincy R.R., they used the stock so acquired as collateral and issued against it collateral trust bonds. Since the stock was acquired at approximately twice its par value, the amount of collateral trust bonds issued was \$200 per share of stock. The control of the Burlington was thus acquired with practically no cash. As long as the dividends paid by the Burlington were double the rate of interest on the collateral trust bonds, it cost the Great Northern and the Northern Pacific nothing to hold the Burlington stock. But when the bonds fell due at an inconvenient time and had to be refinanced at higher rates of interest, and when Burlington dividends were reduced, the position of the holding companies changed materially.

Collateral trust bonds were also used effectively in railroad expansions, some of which involved consolidations. For example, Harriman used them quite effectively in building up his great railroad empire. When he obtained control of a railroad by the purchase of a controlling interest in its common stock, he first proceeded to make the railroad's securities attractive to investors by putting it on a better earnings basis. Being a successful operator as well as a successful financier, he could usually demonstrate better earning power than his predecessors. With a good demand for the stock which he owned, Harriman used it as collateral for bonds whose proceeds were then used to purchase control of some other railroads. By continuing this process, he was able to obtain control over a very large railroad mileage.

**Leases.**—A great many railroad consolidations were effected by the use of various types of leases. By this means, the lessee was able to bring about unified control without resorting to the purchase of the property. In the

early years of railroad consolidation, many leases were arranged on the basis of paying to the lessor a rental contingent upon the happening of some uncertain event. Because of the uncertainties of future railroad business, the lessee was hesitant to commit itself to pay a fixed rental. The most common type of payment was an agreement on the part of the lessee to pay to the lessor a percentage of each revenue dollar.

For example, the perpetual lease of the Mahoning Coal R.R. Co. to the Lake Shore and Michigan Southern Ry. Co., assumed by the New York Central R.R. Co., provides for an annual rental of 40 per cent of gross earnings. Dividends on the common stock of the lessor have been paid as follows: from date of lease in 1884 to 1908—10 per cent; 1909—12 per cent; 1910 and 1911—70 per cent; 1912—20 per cent; 1913—70 per cent; 1914—60 per cent; 1915 to 1919—50 per cent; 1920—110 per cent; 1921—50 per cent; 1922 to 1924—80 per cent; 1925 to 1931—100 per cent; 1932—62½ per cent; 1933 to 1936—50 per cent. From 1936 to 1942, the rates varied from 42 to 76 per cent. This illustration shows how valuable gross-earnings leases may become to lessor corporations. Lessees have sometimes been able to avoid the burdens of such leases by buying up the stock of the lessor over the years. At the time the lease was made, the lessee needed 60 to 70 per cent of the revenue dollar to pay operating expenses. Hence to pay 30 to 40 per cent for the use of the property seemed a fair return. But when the investment of the lessor remains stationary, while that of the lessee continues to increase indefinitely as traffic demands grow, the original amounts paid under such a lease may be increased several times during the life of the lease.

Less frequently, the amount of rental is determined by the net income derived from the use of the leased lines. The rental may be either all the net earnings or an agreed proportion. In either case, an opportunity for manipulation of the rental payments is present. Suppose, for example, that the lessee sees fit to juggle charges in such manner that maintenance costs on the leased property are unusually high. The lessor is seldom in a position to do anything about such manipulation. Even in the case of gross-earnings leases, the lessee may fix the distribution of interchange traffic rates in its favor. But the chances for manipulation are not so great as in the case of net-earnings leases. Wherever the rental payments become burdensome to the lessee, there is an incentive to purchase the stock of the lessor whenever advantageous opportunities are offered.

**Fixed Rental Leases.**—In some of the early leases and in all those which have been drawn in more recent years, the amount of rental is fixed rather than contingent upon earnings. The rent payments follow a variety of patterns but usually include the following charges:

1. A stipulated amount sufficient to maintain the corporate existence of the lessor, paying a nominal salary to its officers, its taxes and other governmental charges, and its office rentals.

2. Interest on the lessor's outstanding bonds.

3. An additional amount to constitute compensation for the equity shares of the lessor. It may be a flat sum to be disposed of as the lessor sees fit, or it may be a fixed rate of dividends distributed by the lessee to the stockholders of the lessor.

Under the 999-year lease of the Carolina, Clinchfield, and Ohio Ry. to the Atlantic Coast Line and the Louisville and Nashville R.R., dividends were guaranteed on the lessor's common stock as follows: 1925 to 1927—3 per cent; 1928 to 1937—4 per cent; 1938 to 2922—5 per cent. Stockholders desiring a uniform dividend rate of 5 per cent for the period 1925 to 1938 could pay \$13.65 per share (representing the annuity value of the dividends in excess of payments under the lease) in return for a regular 5 per cent dividend. The lease of the Rensselaer and Saratoga R.R. Co. to the Delaware and Hudson R.R. Corp. provides for \$1,000 per year organization expenses, interest on bonds, and 8 per cent on capital stock. Since the lessee did not agree to pay income taxes, dividends have been reduced on account of this charge. Dividend payments in recent years have been as follows: 1934—6.8998 per cent; 1935—6.9003 per cent; 1936—6.8999 per cent. With the prospect of higher corporate income taxes for years to come, some of these dividends may shrink considerably.

Other types of rental payments under railroad leases are shown in the table on page 662.

**Other Forms of Consolidations.**—Even where leases are used, it is a common practice for the lessee to acquire stock of the lessor corporation. This may start with minority ownership, to be increased to a controlling interest as the opportunity to buy additional stock under favorable terms is present. Eventually, the remaining minority stockholders may be completely bought out as a preliminary to a complete merger of the lessor company. Control over the lessor may be obtained with a relatively small investment, due to the large proportion of bonds in its financial plan, which the lessee need not buy to obtain control.

As an alternative to the purchase of stock of railroad corporations to be consolidated, the consolidating company may exchange its stock for that of the companies to be taken over. The New York Central R.R. Co. was formed in this manner. Other companies have used this means to strengthen their control over their leased lines without the expenditure of cash. Since the market for the securities of the leased lines is usually a very narrow one, some security holders are glad to exchange their holdings for the stock of the lessee since they can know the value placed upon it day by day by a review of quoted prices.

In a few instances, one railroad corporation has acquired the property of another by outright purchase of its assets. In the rare instances where this has happened, the purchased company is usually a small closely owned

Lessor	Lessee	Annual rental
Freehold and Jamesburg Agricultural R.R. Co. . . . .	Pennsylvania R.R. Co.	Net earnings
New York and Fort Lee R.R. . . . .	Erie R.R. Co.	\$0.01 per ton mile
Pittsburgh, McKeesport and Youghiogheny R.R. Co. . . . .	Pittsburgh and Lake Erie R.R. Co.	\$1 per loaded freight car
Youngstown and Ravenna R.R. Co. . . . .	Pennsylvania R.R. Co.	4 per cent of cost of road
Nypano R.R. Co. . . . .	Erie R.R. Co.	Interest on first 4s
Greenbrier, Cheat and Elk R.R. Co. . . . .	Western Maryland Ry. Co.	\$1, taxes and other fixed charges, expenses, and damage claims
Cleveland and Pittsburgh R.R. Co. . . . .	Pennsylvania R.R. Co.	7 per cent on regular stock
Dayton and Michigan R.R. Co. . . . .	Cincinnati, Hamilton and Dayton R.R. Co.	8 per cent on preferred and 3½ on common
Albany and Susquehanna R.R. Co. . . . .	Delaware and Hudson R.R. Corp.	Interest on bonds and 9 per cent on stock
Michigan Central R.R. Co. . . . .	New York Central R.R. Co.	50 per cent on stock
Providence, Webster and Springfield R.R. Co. . . . .	Boston and Albany R.R.	25 per cent of gross revenue
Morris and Essex R.R. Co. . . . .	Delaware, Lackawanna and Western R.R.	7 per cent on stock and 1 per cent bonus with unusual earnings
Kansas City and St. Louis R.R. Co. . . . .	Chicago and Alton R.R. Co.	35 per cent of gross, less taxes and assessments, with limit of 6 per cent on preferred stock and 7 on common
Central Ohio R.R. . . . .	Baltimore and Ohio R.R.	35 per cent of gross for 5 years, 40 thereafter, minimum \$166,000
New Castle and Beaver Valley R.R. . . . .	Pittsburgh, Fort Wayne and Chicago Ry. Co.	40 per cent of gross, minimum \$40,000

concern that finds independent operation disappointing. It may have been built through the enthusiasm or the civic pride of a few local citizens who thought they were serving their community in this manner. Failing to work out traffic agreements with connecting railroads in advance, they may find the managers of the latter in a noncooperative mood after the little road is constructed. As a last resort, and perhaps to avoid the continuance of

operating losses, the owners of the smaller road may sell out their property to the larger company.

**Guaranteed Securities.**—Out of the railroad leases came the common practice by the lessee of guaranteeing the bonds and stocks of the lessor company. In assuming the obligation to pay a fixed rental to the lessor company, the common practice was to provide for the payment by the lessee of interest charges and a fixed dividend on the stock of the lessor company. In this way both the bonds and the stock of the lessor became debenture obligations of the lessee. In case the bonds matured within the period of the lease, it became necessary for the lessee to arrange for their refunding. Usually the lessee assumes the obligation for the payment of the principal of the guaranteed bonds, as well as their interest charges. In the case of guaranteed stocks, only the dividends would be guaranteed since the stocks would not have a maturity date.

**Preferred Stock.**—Only a little more than a third of Class I railroads use preferred stock of any kind. Of those that have preferred stock in their financial plans, three plans are followed in its issue. In the greatest number of issues, railroad preferred stock resulted from reorganizations. When the failed corporations found that they were unable to meet their fixed charges, they induced some of their bondholders to accept preferred stock in exchange. In such cases, the preferred stock usually carries a low rate of dividends which is sometimes noncumulative. In other cases, preferred stock that is exchanged for bonds as a result of reorganizations is cumulative. Most of the cumulative preferred stocks issued in railroad reorganizations are of fairly recent origin. In a few instances railroads have been able to sell preferred stocks to obtain new capital. None of these have been recent.

**Transportation Act of 1920.**—By the end of the First World War, the funded debt of American railroads had grown to a point where it exceeded 55 per cent of their total capitalization. Meantime, while the Interstate Commerce Commission controlled freight and passenger rates, it had no control over railroad security issues. The Cullom Committee, whose report to Congress in 1886 resulted in the passage of the Interstate Commerce Act of the following year, opposed Federal control over railroad finance. About half of the states had passed laws on the subject, ranging from mere publicity to complete control over the issuance of both stocks and bonds by state railroad commissions. Since most of the important railroads were interstate in the scope of their operations, state legislation on security issues was easily evaded.

During the First World War, the Federal government operated the railroads of the country as a war measure. With the return of the railroads to their owners in 1920, steps were taken to protect their earning power. The Transportation Act of 1920, among other things, gave to the Interstate Commerce Commission complete jurisdiction over the issuance of new

securities except notes maturing in less than two years. The commission was empowered by this law to approve the amount of new securities to be issued by any railroad corporation, the purpose of the issue, and the disposition of its proceeds. Also under this act, no new construction may be undertaken and no facilities may be abandoned without the approval of the commission.

**Combinations.**—On the subject of railroad combinations, the Transportation Act of 1920 took a different attitude than was characteristic of previous legislation. Congress recognized the desirability of combinations of railroad corporations, provided that continued competition was assured. In the first place, it took steps to prevent one company from combining with another, whether through stock ownership or lease, without the approval of the commission. In the second place, the commission was directed to draw up plans for consolidating all railroads in the country into a limited number of competing systems. Since the commission's authority ends with the submission of plans to the railroad managements or with the approval of plans submitted by these managements, it has no method of compelling action. It publicized plans in both 1921 and 1929. Conflicts in ideas among railroad executives, coupled with the prolonged depression following 1929, have combined to prevent any action to date.

**Fair Value.**—With the memory of past railroad financial manipulations before them, the elder LaFollette and his group in Congress had attacked railroad financial plans because of the alleged presence of too much waste. In the effort to prove their contentions, they secured the approval of Congress to have railroads evaluated. After a long and expensive investigation, it was determined that, in the aggregate, the fair value of railroads for rate-making purposes was in excess of their capitalization. Apparently uncaptialized improvements, increases in land value, and the rise in the price level had been overlooked by the LaFollette group. This fair value is supposed to be the base upon which rates for railroad service are to be calculated. However, the competition of trucks, busses, airplanes, and private automobiles has created so many problems for the railroads that, temporarily at least, the rate base has not been the determining factor in fixing railroad rates.

**Financing in the 1920's.**—Railroad managers were glad to get their properties back after the period of government operation from 1917 to 1920. There had been considerable talk of permanent government ownership and operation of all railroads. Managers feared that this discussion might lead to action. This fear motivated some of their actions. Economies of operation were introduced, revenues increased with the prosperity of the 1920's, and some improvements in financial plans were effected. When the railroads were turned back to their owners, rehabilitation programs of various kinds were needed. During the years from 1921 to 1924, investments in road



and equipment increased \$1,700,000,000. Bonds increased approximately \$1,000,000,000; stocks \$338,000,000, and surplus \$580,000,000 during this 4-year period. During the 5-year period from 1925 to 1929, however, bonds increased only \$9,000,000, while stock increased \$738,000,000, and surplus increased \$1,500,000,000.<sup>1</sup>

It is probable that many railroads could have used the boiling stock market of the late 1920's to decrease their burdens of fixed charges by refunding a considerable portion of their bonds with stock. Industrial corporations made this substitution. In doing so, they followed a practice that was long associated with industrial financing. In failing to refinance bonds with stock, railroad corporations followed a practice that was long established in railroad finance. Had the railroad managements been able to foresee the extent of the depression that followed, it is likely that they would have engaged in more extensive refunding operations during the decade of the 1920's.

**Holding Company Finance.**—Since 1870, the Pennsylvania Railroad Co. has made extensive use of the holding company device to finance its varied allied corporations. In that year, the Pennsylvania legislature chartered the Pennsylvania Co. for this purpose. Other holding companies have been used sporadically in railroad finance. It was not until 1921, however, that the holding company was proposed as the means of effecting railroad combinations on a grand scale. Several years previously two brothers, Van Sweringen by name, were real estate operators in Shaker Heights, a suburb of Cleveland, Ohio. Here they owned and had under option thousands of acres of land that they hoped to develop as a part of metropolitan Cleveland. To make a stronger appeal to the home buyers of that city, they needed faster transportation from their development project to downtown Cleveland. After futile attempts to induce the managers of the Nickel Plate R.R. to provide fast suburban trains, the Van Sweringens decided to purchase a controlling interest in the railroad and to provide their own transportation.

They contracted to pay for the controlling interest in the Nickel Plate the sum of \$8,000,000, payable \$2,000,000 down and the balance in installments spread over a period of 10 years. They borrowed the original \$2,000,000 and subsequently paid off this loan from the proceeds of the sale of a part of the stock of the Nickel Plate Securities Corp., a holding company organized to hold the stock purchased by the Van Sweringens. From this point on the story becomes quite involved, with a series of more than a dozen holding companies having the Alleghany Corp. at the top. More than 14,000 miles of single-track railroad, extending over a territory that was truly national in scope, and with a capitalization that exceeded \$2,000,000,000, were soon controlled by the Van Sweringens. The aftermath, with the death

<sup>1</sup> Interstate Commerce Commission, Statistics of Railways in the United States, Annual Reports 1921-1929, *passim*.

of the Van Sweringen brothers and the dissolution of their railroad empire, is not a matter of interest at this time.

The holding-company pattern set by them was apparently not intended to be the permanent form of controlling the railroads included in its system. Instead it was the hope of its promoters that eventually all holding companies as well as wholly owned subsidiaries would be eliminated, in order that the financial and operating plans of the system could be simplified. As it developed, the Van Sweringen system hoped to meet the approval of the Interstate Commerce Commission as an example of the kind of railroad combination contemplated in the Transportation Act of 1920. While it looked for a time that other similar plans might follow the Van Sweringen pattern (as a matter of fact the Pennroad Corp. was organized by the Pennsylvania Railroad along similar lines), the depression of the 1930's and the dissolution of the Van Sweringen system have at least postponed further action.

That both the user of railroad facilities and the investor would be better served by the combination of all railroads of the United States into a few systems is now pretty generally accepted. Just how or when this will be brought about no one seems to know. The Interstate Commerce Commission lacks the authority to compel combinations and the jealousies and ambitions of railroad managers stand in the way of cooperative action that promises results which are likely to meet with public approval. Meantime, the prolonged depression of the 1930's followed by the tremendous increase in railroad traffic resulting from the war effort of the 1940's have resulted in some new complications in railroad finance.

**Railroads in the Depression.**—The combination of reduced traffic during the depression, the increasing competition of other types of carriers, and the heavy burden of fixed charges carried railroads to the lowest depths in their financial history. By 1932, gross operating revenues for all railroads were only half as large as in 1929. Net operating income was only half of the amount due for interest and rentals. And the net income for the year for all railroads together represented a deficit of \$139,000,000. Only one-fourth of the Class I mileage earned its fixed charges. In spite of the fact that the Reconstruction Finance Corporation and the Public Works Administration came to the rescue of the railroads by lending them nearly a billion dollars, by 1938 a third of the Class I railroad mileage was in the hands of receivers or their equivalent.

This equivalent took its authority from an amendment to the Federal Bankruptcy Act which became effective on Mar. 3, 1933. Previous to this time, railroad reorganizations had been cumbersome because, in the effort to be fair to every party at interest, equity receiverships had been the victims of honest minority groups which hoped for a better settlement than was offered them and of dishonest minorities whose sole interest was to blackmail

majority representatives into settlements that gave such minorities unfair advantages. Since complete agreement on any plan of reorganization had been necessary if foreclosure proceedings were to be avoided, efforts at voluntary reorganization had been unduly hampered by the difficulties of getting all parties to agree upon any specific program. As a consequence, equity receiverships were slow in operation and unduly expensive. Protective committees had difficulty in reaching agreements, partly because their members were not always truly representative of their constituents.

The extent of railroad receiverships and trusteeships during the decade of the 1930's, in contrast with the experience of the previous decade, is shown in the following table:

RAILROADS PLACED IN RECEIVERSHIP OR TRUSTEESHIP\*

	1920-1929	1930-1939
Number of companies . . . . .	79	110
Total mileage . . . . .	22,000	80,000
Face value of bonds and stock . . . . .	\$1,290,000,000	\$5,720,000,000

\* Moody's *Manual of Railroads*, 1941, p. a 39.

**Section 77.**—Section 77 of the Federal Bankruptcy Act provided for the reorganization of railroads while they were under the jurisdiction of a trustee in bankruptcy. The chief feature of this amendment dealt with minority interests. After a plan of reorganization is formulated, it must be submitted to the creditors and the stockholders for approval, except that creditors whose interests will not be adversely affected by the adoption of the plan and those whose claims are paid in full in cash are not asked to vote on it. Also stockholders are not asked to vote on the plan if their interests will not be adversely affected, if the corporation is insolvent and the stockholders have no equity, or if provision is made for payment of their equity in cash. If the holders of two-thirds of each class of stocks and bonds approve, the plan becomes effective as soon as it receives the sanction of the Interstate Commerce Commission and the court in whose jurisdiction the case rests.<sup>1</sup> Incidentally, ancillary receiverships were eliminated, as well as the need for finding cash to satisfy the established claims of protesting minorities. Meantime, while a plan of reorganization is being worked out, the railroad is managed by the trustee in much the same manner it had formerly been operated by the receiver. Upon confirmation of a reorganization plan by the judge, it shall become binding, subject to the right of judicial review, upon

<sup>1</sup> Even without such approval the court may put the plan into effect if it finds that such plan affords fair and equitable treatment to those who have rejected it and that it conforms to the requirements of Section 77 of the Bankruptcy Act.

all creditors and all stockholders, whether or not they filed claims and whether or not they indicated their approval of the plan.

In the operation of Section 77 and its amendments, the Interstate Commerce Commission and the courts exercise a large measure of control over the plans of reorganization. Since no plan can become effective without the approval of these two governmental agencies, it is to be expected that plans that will be proposed will have the advance sanction of the commission at least. Both the commission and the courts must be expected to keep uppermost in their thinking the public interest in the continued operation of the railroad. This interest will be balanced against the financial claims of bondholders and stockholders. This means that Section 77 has effectively modified existing contracts in the form of railroad bonds and stocks. Only when these contracts can be carried out at the same time that the larger public interest is served will they be enforced as originally written.

The law is quite specific on the subject of contractual changes, reading in part as follows:

A plan of reorganization . . . (1) shall include provisions modifying or altering the rights of creditors . . . secured or unsecured, either through the issuance of new securities of any character or otherwise; (2) may include provisions modifying or altering the rights of stockholders . . . (3) may include, for the purpose of preserving such interests of creditors and stockholders as are not otherwise provided for, provisions for the issuance . . . of options or warrants . . . (4) shall provide for fixed charges . . . in such an amount that, after due consideration of the probable prospective earnings of the property in light of its earnings experience and all other relevant facts, there shall be adequate coverage of such fixed charges . . . (5) shall provide adequate means for the execution of the plan.

**Leases.**—One feature of Section 77 is of particular interest to the holders of securities of leased lines. The law provides as follows:

If a lease of a line of railroad is rejected, and if the lessee, with the approval of the judge, shall elect no longer to operate the leased line, it shall be the duty of the lessor at the end of a period to be fixed by the judge to begin operation of such line, unless the judge, upon the petition of the lessor, shall decree after hearing that it would be impracticable and contrary to the public interest for the lessor to operate the said line, in which event it shall be the duty of the lessee to continue operation on or for the account of the lessor until the abandonment of such line is authorized by the Commission.

**Tendencies.**—In the plans of reorganization that have been approved to date, several tendencies are evident. Paring down of fixed charges has been more realistic than was formerly the case. Evidently there is an intent to make sure that the fixed charges assumed by the reorganized corporation can be earned without question. The order of priorities in requiring sacrifices of old security holders is not so strictly observed as formerly. There is a

tendency to ask all to share the burdens of the reorganization process. Where the Reconstruction Finance Corporation has a stake in the reorganization because of money borrowed from it by the railroad corporation before it was reorganized, some plan of carrying this claim along with private claims is necessary. For example, in the reorganization of the Chicago and Eastern Illinois R.R. Co. in 1941, the R.F.C. took a first mortgage for approximately \$11,000,000 in satisfaction for its loans of an equivalent amount. But it also named three members of the new board of directors. It will be interesting to watch the implications of this kind of procedure.

The effects of the recommendations of the Interstate Commerce Commission upon the capital structures of the first 21 railroads which were reorganized under Section 77 are shown in the following table:<sup>1</sup>

	Number	Long-term debt (000 omitted)	Stock	
			Par value (000 omitted)	No-par shares
Old companies . . . . .	21	\$2,994,494	\$1,379,063	1,476
New companies . . . . .	20	\$1,593,269	\$706,011	12,145
Difference . . . . .	-1	-\$1,401,225	-\$673,052	+10,669
Per cent change . . . . .	...	-47	-49	+723

Up to Oct. 31, 1944, 43 railroad companies had filed applications under Section 77. Of these, the Interstate Commerce Commission had approved reorganization plans for 29, requiring that the long-term debt of \$3,175,609,000 (\$4,056,426,489 if the unpaid interest be included) be reduced to \$1,749,573,800, much of which was to be in the form of income bonds. By these changes the obligatory fixed charges would be reduced from \$141,580,228 to \$39,120,559.<sup>2</sup>

**Current Railroad Finance.**—The Second World War, with its unprecedented demands upon railroads, offered a new ray of hope to their managers. Many of them, incidentally, appear to be finally convinced that much of their trouble stems from their heavy overload of fixed charges. Perhaps the announced conviction of the Interstate Commerce Commission that bonds issued hereafter should be sinking-fund bonds aided the conclusions of the managements. Also, some of them at least have not forgotten how close to reorganization their companies slipped in the decade of the 1930's. As a consequence, with sharp increases in both gross and net earnings during the early 1940's, managements are using their surplus cash to pay off their

<sup>1</sup> Stevens, W. H. S., *Journal of Business*, July, 1942, p. 207.

<sup>2</sup> Annual Report of the Interstate Commerce Commission, Washington, 1944 pp. 14-15.

current obligations and even to buy up their funded debt at greatly depressed prices. The war lasted long enough to make substantial changes in the amount of the debt outstanding by this means. Also the early maturities were anticipated in sufficient quantities to give many railroads a new lease of life for the near future. For example, the Pere Marquette Ry. was able, by the early part of 1945, to reduce its debt 22½ per cent and its fixed charges by 42 per cent, as compared with 1942. A part of the interest reduction was due to refunding at low interest rates some of its higher rate bonds. As a class, railroads whose bonds were not in default reduced their bonded indebtedness from \$12.6 billions in 1933 to \$9.8 billions in 1943; preferred

Year	Per cent net income to stock	Year	Per cent net income to stock
1934	0.23	1939	1.44
1935	0.53	1940	2.49
1936	2.23	1941	5.87
1937	1.49	1942	10.45
1938	....	1943	10.03

stock was reduced from \$2 billions to \$1.9 billions; and common stock from \$8.0 billions to \$7.5 billions. Further reductions were made in bonds after 1943.

The Second World War experience of American railroad revenue and income was the best in years. Not only did the traffic increase materially—so much so in fact that priorities for railroad service were necessary—but the competition of automotive vehicles of all kinds was substantially reduced, due to the rubber and gasoline shortages. The war prosperity of the railroads, indeed, was much more definite than for many industrial corporations, partly because of the much heavier taxes on the earnings of the latter. Of 450 corporations, with stock listed on the New York Stock Exchange, which reported their net earnings to the Exchange for the first six months of 1942, the railroad group of 42 corporations showed an increase in net earnings over the corresponding period of 1941 of 42.6 per cent. Every other substantial industrial group reported less net earnings in 1942 than in 1941. The decreases ranged from 2.9 per cent for mining corporations to 51.3 per cent for automobile companies. The average decrease for the 450 companies, including the 42 railroads, was 19.3 per cent.<sup>1</sup> The effects of the war prosperity on the earnings of American railroads is shown in the above table of per cent of net earnings to the book value of the common stock.<sup>2</sup>

But while railroad managers are basking in the sunlight of present-day increased earnings, they look with apprehension upon the clouds of tomorrow.

<sup>1</sup> Reported in *Wall Street Journal*, Aug. 21, 1942.

<sup>2</sup> Annual Report of The Interstate Commerce Commission, Washington, 1944, p. 125.

Section 77, whose average earnings for the years 1939 to 1945 were equal to or greater than its fixed charges for the period, could be returned to the management for the purpose of reorganization. The debtor corporation must proceed at once to formulate a method of rebuilding its financial plan under Section 77. It was expected to consummate such plan within a period of 18 months, or such extension thereof as may be granted by the court. Failing to effect a new plan within that period would have caused the corporation to be returned to the trustee (or a new trustee) for reorganization as originally intended.

The railroads affected by this amendment constituted about one-fourth of the railroad mileage of the United States. The effect of the amendment would have been to reduce the authority of the Interstate Commerce Commission in the formulation of reorganization plans and to substitute increased authority of the management which, presumably, would have represented the interests of the stockholders. As a result, the stockholders should have received more generous treatment than has been customary in previous reorganizations under Section 77. This amendment did not apply to any railroad corporation which, at the time of filing a petition under Section 77, had more than 90 per cent of its voting stock owned or controlled by another railroad corporation. Because the President vetoed this bill after Congress adjourned, it did not become law.

### QUESTIONS AND SUGGESTIONS

1. How important are railroad finances in comparison with the total for all corporations?
2. What changes in railroad financial plans have been made over the years? How were early railroads financed?
3. Describe the first period of railroad consolidation. What were its objectives?
4. How was the construction company used in the financing of railroads? Why were many early railroads overcapitalized?
5. Describe the second period of railroad consolidations, and state its objectives.
6. How did the third period differ from the second?
7. Who was E. H. Harriman, and what was his part in railroad finance in this country?
8. What are underlying bond issues? Are they more or less secure than overlying issues? Why?
9. How were collateral trust bonds used in railroad consolidations?
10. How were leases used for consolidation purposes? What kinds of fixed rental leases have been used? How do lessees get out from under the burdens of gross rental leases?
11. What are the other forms of railroad consolidation?
12. What is the origin of most railroad preferred stock?
13. What did the Transportation Act of 1920 say about consolidation of railroads? About control over finances? Why have railroads made so little use of the proposals for consolidation in this law?
14. Account for the experience of the railroads in their financing operations during the 1920's.

15. To what extent have railroads used holding companies?
16. What were the purposes of Section 77 of the Bankruptcy law?
17. What governmental agencies must approve financial plans in reorganizing railroads?
18. What are the outstanding features of plans adopted to date under Section 77?
19. What are the characteristics of current railroad finance?

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#### SUBJECTS FOR INVESTIGATION

1. Compare the financial plans of five well-known railroads with those of five well-known industrial corporations, and note any differences that you find.
2. List the various kinds of bonds that you find in the New York Central or the Pennsylvania railroad systems.
3. Find a railroad that is reducing the proportion of its bonds to its total capitalization and one that is not doing so to as great an extent.



## CHAPTER XXXVIII

### PUBLIC ATTITUDE TOWARD COMBINATIONS

**Methods of Expression.**—The attitude of the public toward business combinations may be expressed in several different ways. Some of these may be in conflict with others at any given time. As consumers, the public may tacitly accept the benefits of combinations by buying without hesitancy the goods and services placed on the market by them; or it may refuse to use such products and services. As producers, the public may accept employment from business combinations and contract freely with them; or it may express its disapproval by looking elsewhere for employment and for business. As investors, the public may buy the securities of combinations whenever profit possibilities seem favorable; or it may discriminate against them and make their financing difficult. By these methods alone the public, if all its members were of the same mind and if they acted alike, could make or break individual combinations or even the whole combination movement. Concerted opposition might be embarrassing to those who joined in the movement by denying themselves the benefits that combinations offer. Nevertheless, if the sacrifices seemed worth while, the results would be inescapable.

In its representative capacity, the public has various means of expressing its attitude toward business combinations. It can elect to governmental posts those who are expected to carry out the public will through the medium of legislation. If the will of the public be to enjoy the benefits of combination, then it is to be expected that the government, as constituted by those in power at the moment, will not harass business combinations. If, on the other hand, the public wishes to be rid of combinations, it expects its representatives to pass the necessary laws and to interpret and administer them in such fashion that the public's will is served. This analysis assumes that the public takes the initiative and picks representatives willing to do its bidding. Actually, the bidders for public favor who run for public office write their own platforms and ask the electorate to express a preference for one economic policy or another in terms of the people elected to office.

As is to be expected, public attitudes toward business combinations change from time to time. What was true at one period might be completely reversed later. A variety of causes produce new results. Also the attitude of the public might favor combination in one industry and oppose it in another. Greater familiarity with new economic processes of any kind gradually wins the acceptance of at least a part of the results that such

processes produce. Discrimination comes with a better understanding of all the elements of what at the outset appeared to be wholly bad. Perhaps we can reach a better understanding of the public attitude toward business combinations if we review the history of these attitudes in this country briefly.

**Legal Attitudes.**—First let us take a look at the legislation governing business combinations and its interpretation. As a background for such discussion, a brief understanding of legal processes will be of assistance. In a democracy like ours, accepted standards of conduct are presumed to be legal until they are proved to be otherwise. In adopting a new policy or fostering a new program of any kind, we need not first have a law to sanction it. All that is necessary is to check with existing prohibitions to see that the plan we have in mind has not already been declared to be socially undesirable. If there are no laws against it, we are at liberty to pursue our voluntary wills until such time, if ever, as our duly elected representatives find it necessary or desirable to pass laws or to interpret those already in use against the new practice. When laws are passed, they generally serve as a check upon existing practices and policies.

**Meaning of Illegal.**—Illegal means against the law. The illegal act may be thoroughly defensible from the standpoint of sound economic principles, good business judgment, and even desirable public policy. The law is not infallible. If up-to-date, it expresses the current opinion of the lawmakers; if not, it states a rule of action considered desirable at some previous time. The city of Detroit has recently given consideration to the repeal of ordinances regulating the driving of geese through the public thoroughfares and the backing of mules over sidewalks. It would be interesting to know how many geese and mules are at present affected by such outworn bits of legislation, still on the statute books and therefore still the law of the city of Detroit.

The law is never a fountain of wisdom from which flows rules of conduct adapted to changing economic and social relationships. It seldom initiates new programs or enunciates new policies. At its best, it acts somewhat tardily to correct abuses in programs and policies originating elsewhere. At its worst, it is invoked by special interests to sanction proposals which, by some curious twist, may appear to enjoy the approval of legal precedent, but which in fact defeat the purposes of those to whom the law is supposed to be responsible and responsive.

The mental processes of individual legislators and jurists may be rigid and static, but the law is more dynamic. With the death, or removal, of obstructing judges and lawmakers, their successors lend a hand to the wheels of progress and give new expressions to the law. With the aid of other jurists and legislators who always attempt at least to keep abreast of the times, laws are amended and repealed or are given new interpretations,

amounting at times to reversals of previous decisions without any change in statutes.

**Eternal Conflict.**—In a democracy such as ours, there is constant and persistent violation of statutes, court decisions, and even constitutional provisions. And yet we call ourselves a law-abiding people. By this we mean that we please to abide by laws that please us. Individually and collectively, we flaunt those which we do not agree with. If our group is large and powerful enough, we make plans to have the courts reinterpret the law in question more to our liking or to have the legislature amend it to suit our fancy. By this means we evade the accusation of being lawbreakers. This eternal conflict between the law and those whose plans are hindered by its enforcement is present in all human relations. Business is no exception and is no particular scapegoat.

**Business Lawbreakers.**—One further explanation of the prevalence of conflict between business leaders and lawmakers will help us to understand the progress of illegal combinations in business. Some lawbreakers are simply crooks—willing to do anything that will redound to their personal advantage. Not all business leaders who commit illegal acts can be so classified. The outstanding characteristic of successful business leadership is the constant search for something new: new products, new methods, new processes, new relationships. Business itself exhibits a curious paradox. It is constantly alert to discover and utilize the economies of standardized production and to reap the harvest of promotional profits resulting from responses to the sales appeal of unstandardized new styles. Whatever else may be said against the capitalistic regime, few would accuse its leaders of unwillingness to experiment. When they become content with things as they are, they cease to be leaders.

The law, on the other hand, abhors experimentation. It may adopt, as its own, methods and processes tried out and proved elsewhere. But, probably very properly, it hesitates to pioneer. It follows the business pioneer and erects stable structures in his wake. The businessman thrives upon the blueprints of air castles, to be constructed in the future. The law insists upon final tests before giving approval to go ahead. The eternal pushing ahead of business leaders comes into necessary conflict with the constant holding back of the law. If the former make their point, the latter eventually yields—but only after a struggle.

**Worship of Competition.**—Aside from certain technicalities of the law, whose breach causes trouble for the corporations involved, most of the reasons for classifying combinations as illegal relate to their monopolistic tendencies. The economic theory of capitalism has always worshiped competition, largely without stopping to follow the logic of its own conclusions. The concept of competition is based upon a figment of assumptions that are seldom realized in business practice. Competition is limited not only by

freedom of action but by unequal intelligence, information, ability, courage, persistence, and all the other qualifications for business success. Furthermore, unrestrained competition, to the extent that it really interferes with the plans of business leaders, is its own antidote. Without competition, there would seldom be need for consolidation. Effective competition usually leads to some form of combination and restraint, laws to the contrary notwithstanding.

**Common Law.**—Common law is crystallized public opinion, which is tacitly followed in unwritten customs. Later it becomes formally enunciated, when necessary, in the decisions of courts. In spite of the thousands of statutes enacted annually by our lawmaking bodies, most of our actions are governed by common law and custom.

As soon as business relations became a factor in organized communities, the fear of monopoly dictated common-law edicts against restraint of trade. For centuries before the enactment of American antitrust laws, contracts that placed upon the contracting parties unreasonable restraints upon the use of capital or labor were unenforceable at common law. Contracts to restrain the trade of third parties were unenforceable whether reasonable or unreasonable restraints were intended. At common law, these contracts were simply void, and the courts refused to aid their enforcement. So long as the contracting parties felt strong enough in their own right to enforce their contracts without recourse to the law, they could enjoy the fruits of trade restraint. Under this system, third parties were the sufferers. The common law did not give them adequate protection against trade restraints.

**Statute Law.**—Common law is court-made law; different courts may make different laws. Furthermore, every case coming before the court is somewhat different from its predecessors. There is always more or less uncertainty about the application of the common law to the circumstances of a particular case. Finally, common law is never sure about meeting a new situation. Dependent upon precedent, it flounders in the face of new conditions that have no precedent. It may take some time for common-law courts to arrive at even a semblance of agreement in their attempts to classify these new conditions. For these reasons, legislatures enact statute laws whose purpose is to clarify the confusion of court decisions at common law, to modify them when new conditions appear to need speedy sanction or repression, or to nullify common law when new solutions of pressing problems are apparently needed.

**Antitrust Acts.**—The antitrust acts of the last century in the United States are excellent examples of revenge legislation. Born of hysteria and fear of new monster monopolies which made their appearance in an effort to lift business out of the prolonged depression of the seventies and eighties, these acts, both state and national, attempted to stamp out the new industrial combinations which were feared alike by competitors and consumers. In

response to an aroused public sentiment, politicians of both major political parties hastened to get on the band wagon and espouse the cause of the small businessman and the consumer. In no unequivocal terms, the intent of the masses of the electorate was speedily written into law. The common-law doctrine of refusing to aid restraints of trade was brushed aside in favor of a new pronouncement making restraints of trade positively illegal, actionable, and even criminal.

By the date of the passage of the Sherman Act, every state had considered antitrust legislation. No less than 14 states had changed their constitutions to prohibit trusts and monopolies, and an additional 13 had enacted statutory prohibitions of a similar kind. The burden of these enactments was (1) to make criminal acts of many contracts unenforceable but not illegal at common law; and (2) to strengthen the common law by condemnation of specific practices that had theretofore been included under such terms as monopoly and restraint of trade. Some states prohibited certain practices such as local price cutting and exclusive dealing.

The language of these statutes left no doubt of their intent. The Sherman Antitrust Act particularly is couched in language so clear and so simple that only lawyers and judges could possibly misunderstand it. Had it been enforced as written, unquestionably all monopolistic tendencies would have been stamped out. Also, the industrial and commercial development of the United States would have received a blow from which there could be slight hope of recovery. Little encouragement could ever have been given to the creation of manufacture and commerce such as we have since enjoyed.

**Background of Sherman Act.**—With ears to the ground in 1888, the leaders of both major political parties had little difficulty in hearing the rumblings of popular protest against monopolies. The Democratic platform of 1888 declared that “the interests of the people are betrayed when, by unnecessary taxation, trusts and combinations are permitted to exist, which, while unduly enriching the few that combine, rob the body of our citizens by depriving them of the benefits of natural competition.” Not to be outdone in the bid for votes, the Republican platform read: “We declare our opposition to all combinations of capital, organized in trusts or otherwise, to control arbitrarily the condition of trade among our citizens; and we recommend to Congress and the state legislatures . . . such legislation as will prevent the execution of all schemes to oppress the people by undue charges on their supplies.”

**Legislative History of Sherman Act.**—In the face of the above declarations by both major political parties, it is not surprising that early action should follow. Bills were introduced into both houses of Congress in 1888 to slay the monopoly monster. No law was passed at that session. In his first annual message to Congress in 1889, President Harrison directed attention to the need for legislation to eliminate trusts organized “to crush out all

healthy competition" and to monopolize the production or sale of necessities. He characterized them as "dangerous conspiracies against the public good" and recommended that they be made the subject of "prohibitory and even penal legislation."

On the following day, Senator Sherman introduced an antitrust measure. Within a few weeks, it became law under the common name of the Sherman Act, although it is well known that the original draft was changed materially in the committees. The conviction of the members of both houses of Congress of the universal demand for this legislation is evidenced by the vote. In the Senate, only one vote was cast against it; in the House, it was passed without a dissenting vote. How much this vote represented a fear of trusts and how much a fear of constituents is not known. The effect was the same in either case.

**The Sherman Act.**—The essence of the eight short sections of the Sherman Act is found in the opening sentences of the first two sections. They read:

Section 1. Every contract, combination in the form of trust or otherwise, or conspiracy, in restraint of trade or commerce among the several States, or with foreign nations, is hereby declared to be illegal. . . . Section 2. Every person who shall monopolize, or attempt to monopolize, or combine or conspire with any other person or persons, to monopolize any part of the trade or commerce among the several States, or with foreign nations, shall be deemed guilty of a misdemeanor.

The procedure of trial and conviction and the penalties follow.

**First Two Decades.**—The Sherman Act became the law of the land in 1890. Almost immediately thereafter, our economic system was subjected to one of those periodic cyclical movements that cause almost everyone to lose interest in everything except the search for a job. The severe depression of the early 1890's took attention away from the fear of monopolies. The question was again dramatized in the presidential campaign of 1896. As the champion of the small businessman, Bryan conducted a vigorous campaign against big business and monopolies. McKinley interpreted his success against Bryan to mean that the hysteria that had resulted in the passage of the Sherman Act was subsiding. When he became president, he did not institute a trust-busting crusade. On the contrary, it was during his administration that the second period of industrial combinations blossomed out with hundreds of combinations. The rise and fall of this movement have already been recorded in an earlier chapter.

By the end of the second combination period, President Theodore Roosevelt began to emphasize the difference between good trusts and bad trusts and to point to the desirability of fostering the good while eliminating the bad. The organization of the Bureau of Corporations in 1903 to study the question resulted from his suggestion and from the exhaustive study of

the Industrial Commission which made a thorough inquiry into the trust problem around the turn of the century. These evidences of definite attention on the part of governmental agencies to the subject of monopolies and the problems created by business combinations were accepted by the public to mean that its interest would be protected

Meantime, the public had received not too much encouragement from the early decisions of the Supreme Court of the United States which attempted to interpret the Sherman Act. The first important case involving an industrial combination was the *E. C. Knight* case which involved the sugar "trust." It was admitted that the trust controlled 98 per cent of all sugar refining in this country. Yet the court drew a hair-line distinction between commerce and manufacture and concluded that the monopoly was one of manufacture only and did not involve commerce. Hence the Sherman Act, which dealt with interstate commerce, was not violated, according to the court. Much to the chagrin of the members of trade unions, the court declared in the *Debs* case that the Sherman Act applied to activities of labor in restraint of trade. All in all, the decisions of the court were not very comforting to the public during the first decade of the history of the Sherman Act.

Then in 1904 came the decision in the *Northern Securities* case, which showed that the Sherman Act was not to be considered to be dead so far as its authority to restrain trade was concerned. While this concerned a railroad consolidation, it involved the holding company principle. The decision of the court tended to serve notice that, if necessary, the same conclusion would be drawn from holding companies used to effect industrial combinations. At any rate, it is generally conceded that this decision was one of the reasons why the second combination period ended when it did. During the next few years, President Roosevelt gained quite a reputation as a trust buster and the courts proceeded to hear the cases brought before them. Actually, more indictments were brought under the Sherman Act during the 4 years of Taft's administration than were brought during the 7 years that Theodore Roosevelt was president.

**Changed Attitude of the Court.**—At the outset, the Supreme Court considered the Sherman Act as an attempt on the part of Congress to nullify the common-law doctrine of conspiracy and to set up in its place an entirely new set of standards. By the end of the second decade after the Sherman Act was made the law of the land, the court made an entirely new approach to its interpretation of this act. The decisions which followed sound almost as if the majority of the court had never heard of the law before. One might almost say that they deliberately reinterpreted the language of the Sherman Act. This new approach was unquestionably a fortunate one for our whole economic system. It followed the pattern set by Theodore Roosevelt in his distinction between good and bad trusts.

While the majority members of the court gave no hint that they were approaching an interpretation of this law from a new angle, the results speak for themselves. Steeped in the lore of the common law, they read into this bit of legislation, not the intent of an aroused public to nullify common-law practices, but the proffer of assistance of a helpful Congress wishing only to clarify and modify existing practices. By judicial decree, the rule of reason effectively amended the Sherman Act. Thereafter, only "unreasonable" restraints of trade were frowned upon by the courts. By this happy solution an aroused electorate was saved from the consequences of its hysterical acts, and the greatest industrial nation in the world proceeded on its way toward prodigal exploitation of natural resources, creation of huge fortunes, development of the highest standards of living the world has ever known, and, in general, the building up of a commercial, financial, and industrial organization that threatens at times to assume the proportions of a Frankenstein.

**Harlan Dissents.**—The dissenting opinion of Justice Harlan in the Standard Oil case both expresses his deep chagrin at the judicial legislation indulged in by the other members of the Supreme Court and reviews the reasons for the Sherman Act. Harlan said in part:

All who recall the condition of the country in 1890 will remember that there was everywhere, among the people generally, a deep feeling of unrest. The nation had been rid of human slavery,—fortunately, as all now feel,—but the conviction was universal that the country was in real danger from another kind of slavery sought to be fastened on the American people; namely, the slavery that would result from aggregations of capital in the hands of a few individuals and corporations controlling, for their own profit and advantage exclusively, the entire business of the country, including the production and sale of the necessities of life. . . . It thus appears that fifteen years ago, when the purpose of Congress in passing the anti-trust act was fresh in the minds of courts, lawyers, statesmen, and the general public, this court expressly declined to indulge in judicial legislation, by inserting in the act the word unreasonable or any other word of like import.

**Dissolution Experiences.**—Having found that, even in the light of the rule of reason, the Standard Oil Co. of New Jersey still had violated the Sherman Act, the Supreme Court ordered this combination to dissolve itself. The management showed that it still retained its mental agility. It will be recalled that when it was indicted and convicted for operating a trust in 1892, it simply took out a charter as a holding company under the New Jersey statutes of 1889. Now that the Supreme Court had ordered the dissolution of this holding company in 1912, the management set up in its place a most effective territorial pool. The various companies into which the holding company was dissolved were each assigned exclusive territories within which to operate. The owners of the holding company stock were given prorata shares of stock in these companies. In other words, the form



of the combination was changed but the fact continued as before, without having the benefits of competition restored. Dissolution proceedings that followed similar decrees of the Supreme Court in other industrial combinations in the years immediately following the Standard Oil decision were not much more effective in restoring competition than in the Standard Oil case.

**Amendments to the Sherman Act.**—From time to time, minor amendments have been made to the Sherman Act in respect to foreign trade, combinations of railroads and steamship companies, and immunity of witnesses in cases brought under the act. The legislation of 1914 attempted the first general overhauling of legislation passed 24 years previously. The Clayton Act of 1914 undertook to give the Sherman law a new set of teeth in the form of various provisions, whose detailed discussion has no place here. The Federal Trade Commission Act of the same year attempted to introduce the device of an administrative commission to aid the courts in minimizing restraints of trade. Because of jealousy of the courts, political pressure, and other causes, the commission has experienced difficulty in fulfilling the hopes of its proponents. Undoubtedly too much was expected of it at the outset. It had too many grandmothers, with conflicting ideas of the career it should pursue. Since 1914, a few further amendments have been made to our antitrust laws, the most important of which was the Webb-Pomerene Act of 1918, a war measure that gave approval to the use by American corporations and others of weapons, to be used against foreign competitors, which are outlawed in domestic trade.

**Congress Sustains Court.**—A careful analysis of the 1914 legislation leads to the conclusion that, in the passage of the Clayton Act, Congress saw fit to sustain the decisions of the Supreme Court delivered a couple of years previously. In framing the Clayton Act, Congress had a good opportunity to express disapproval of the judicial legislation that resulted in reading the rule of reason into the Sherman Act. Instead, Congress upheld the Court's decisions and agreed that certain acts are unreasonable and should be prohibited. These include (1) local price discriminations which substantially lessen competition or tend to create a monopoly, (2) exclusive selling or leasing contracts having a similar effect, (3) holding companies which produce similar results, and (4) interlocking directorates.

**Recent Court Decisions.**—Recent decisions of the Supreme Court under the antitrust laws have demonstrated the possession by the majority of that body of a sense of humor. After futile attempts at the unscrambling of corporations declared to be in unreasonable restraint of trade, the court, by its usual majority in important antitrust cases of a single vote, has supplemented the rule of reason with the rule of expediency. The latter recognizes the fact that some dissolution decrees have been mere gestures and refuses to lead the court into similar impotent positions. Neither size nor latent

power seems any longer to interest the majority of the justices. Conduct is considered paramount. It is fairly easy for business leaders to learn good manners. Textbooks on economic theory apparently do not occupy important places on the shelves of the Supreme Court library. Recent decisions approve the elimination of the wastes of competition and the addition of the benefits of integration.

**Consent Decrees.**—About half the civil suits brought under the Sherman Act resulted in consent decrees. Of the 112 consent decrees entered from 1906 to 1932, 55 came in the last 8 years of the period. This increase is undoubtedly due, at least in part, to the clarification of the law by repeated decisions. Business leaders will meet the government halfway to avoid the disorganization, expense, and publicity accompanying antitrust litigation. The result has been termed "law enforcement by negotiation."

**Trade-association Cases.**—Both the Federal Trade Commission and the courts have made heroic efforts to understand the trade-association movement and its implications and effects upon restraints of trade. Because of the multifarious activities of such associations, some of which affect competition directly, while others have only remote relationship, both courts and commission have done considerable fumbling in their decisions to date. As a consequence, trade associations have not known what they could and could not do without running afoul of the law. Eventually, an understanding will be reached. Meantime, the uncertainty of legality of trade-association activities has encouraged the organization of mergers and consolidations whose rights and obligations have been more clearly adjudicated.

**Public Attitude.**—Also, the enjoyment of the benefits of industrial combinations has tempered public opposition to them. Today only politicians who fail to read the signs of the times make blanket condemnation of industrial combinations. The Sherman Act is still the law of the land. Its repeal has been discussed from time to time, particularly in recent years, but no aspirant for high office has had the courage to stake his political fortunes upon such a cause. This law remains on our statute books as one of our intangible totem poles. No one takes the original wording of the act seriously. No congressman or president could be elected on a platform that promised rigid enforcement of the Sherman Act as it was interpreted before the Supreme Court read into it the rule of reason.

For the most part, the public has decided to leave to the governmental agencies any expression of opposition to business combinations. Labor unions do not hesitate to sign agreements with all kinds of business enterprises, large or small, combined or otherwise. Purchasers of securities buy whatever they think will produce the most satisfactory results in interest, dividends, and price increases. Whether the issuer of the security is a combination or not does not enter into the decision. From the standpoint of the consumer, purchases are usually made where the best prices can be

had, quality considered. In some instances, the consumer exercises a choice of distribution outlets that may favor the combination or may oppose it, according to circumstances.

**Distribution Combinations.**—For example, the phenomenal growth of chain stores in recent years could not have taken place in the face of definite opposition from the buying public. So far as the retail chains are able to give the public what it wants at a price lower than it would be required to pay elsewhere, they will probably continue to meet with public favor. It is well recognized that they make their strongest appeal by offering only basic services with their commodities, leaving to their independent competitors the task of providing special services for which higher charges are expected. "Cash and carry" has become a slogan which is intended to measure the quality of services rendered by chain stores. The quality of the goods handled by chain stores may satisfy their customers without question. Indeed the same goods may be handled by both chains and independents. In general, the advantages that the chains have over some independents comes from more economical purchases of the commodities for which there is the greatest demand and from avoiding the high-cost services that many customers object to paying for. Over-all management of chain operations is usually superior to that of their competitors. Management of individual stores and personal relations with customers throws the balance in favor of the independents. That is why the latter are more likely to succeed where a high degree of personalized service is required.

**Combinations in Capital Industries.**—In contrast to the types of business in which personal service is a determining factor in customer relationships, we find, at the other extreme, those industries whose products bear no hallmarks of their producers. While the finished product may bear the trade-mark of the company that sells it, it may not in any manner be distinguishable from innumerable units of the same make. The personalities of the producers leave no impression upon the product. It is the machine that is the dominant factor in the production process. The human factor is needed because, to date, no machine has been invented to contribute the part that human labor is expected to supply. Whenever machines are invented that will successfully perform parts of the work at present contributed by humans, the productive process will be made even more automatic than it is at present.

The constant introduction of laborsaving devices into industrial establishments formerly met with greater opposition from labor than has been true recently. Technological improvements have frequently resulted in technological unemployment. Formerly those who were about to be displaced by machines objected and fought their dismissal. More recently, we seem to have adopted a philosophy that expects industrial progress to pay the cost of scrapping human labor as well as obsolete machinery.

At any rate, it is unthinkable that we should ever abandon our dependence upon great concentrations of capital invested in the productive mechanisms of many of our basic industries. So great is the investment required in the production of steel, for example, that the development of new corporations in this industry hardly seems probable. Here at least great concentrations of wealth, mostly brought about by combinations of competitors in years past, are looked upon by the public as desirable and necessary for the production of the products we need. In other industries, like the automobile-manufacturing business, the concentration of wealth required for successful competition makes the entry of new companies very difficult to say the least.

Likewise, the public favors whatever integration of industry will produce beneficial results for consumers, producers, and investors. "Integration" is a word that is frequently used to create a favorable impression but whose results do not always justify expectations. Under favorable circumstances, it means bringing together under one management various processes or steps in the industrial process in such manner that the most efficient results will follow. There are various degrees of integration. A clothing manufacturer might see fit to open a series of retail outlets for the final disposition of his products. This would be classed as integration, but so also would his growing of sheep and cotton to supply his raw materials and his management of a chemical plant to produce his dyes. Automobile manufacturers have carried integration to the point of manufacturing their own steel. Tire manufacturers have experimented with the growing of rubber and the management of cotton textile mills. It is difficult to generalize on the subject of integration because there is no practical limit that can be placed upon its application in any particular industry except such as is dictated by the judgment of business managers. This is not always reliable. Unquestionably the public favors integration where it receives a benefit. It is likely to frown upon it if the opposite results follow its use.

**The Road Ahead?**—Prediction is always dangerous. Nevertheless, tendencies can be noted. From the sufferings of the prolonged depression, accentuated by the succeeding recession, there have arisen demands for correction of existing economic evils of all kinds. Personification of guilt always wins converts. It is easy to convince great masses of our people that many of their woes are to be blamed upon the few who control the destinies of large corporations. That calls for another crusade of "trust busting." Such a crusade was just getting under way when the Second World War was thrust upon us. One paradox of the First World War was that this world-wide conflict, which forced international cooperation on a scale never before approached, should have been followed by an aftermath of extreme nationalism. The state trusts of Russia, the dictatorships of Germany and Italy, the interempire trade alliance of the British Empire—

all looked toward nationalistic supremacy. In the United States, the war period permitted, and even forced, a degree of intercorporate cooperation which bore fruit in the tremendous number of mergers and consolidations in the following decade. Our tariff policy is and always has been distinctly nationalistic. The Webb-Pomerene Act fosters attempts at monopolistic control of foreign trade. Stabilization supporters look with longing eyes at further liberalizing of antitrust laws. Meantime the Second World War again forced intercorporate cooperation on unprecedented scales.

**Eternal Conflict.**—And so the eternal conflict of law and business organization continues. The former is continually making adjustments to indicate sanction or disapproval of the plans of the latter. The latter is continually finding new ways to circumvent the former. The label of illegality has never been a preventive of economic success. The law has at times retarded and caused postponement of economic plans. History is full of illustrations of conflicts between law and economic principles. Where the latter are sound, they have usually emerged from the conflict victorious. Some victories over the law have been won, not on merit, but on the strength of the power of special interests. Such victories are not always final.

### QUESTIONS AND SUGGESTIONS

1. Would you buy the products of an industrial combination? Why? Would you accept employment from it? Why? Would you invest in its securities? Why?
2. In what other ways might you, as a citizen, express your attitude toward industrial combinations?
3. What is the meaning of illegal? What is law?
4. Who are business law breakers? Why are they so classified?
5. Does a worship of competition eliminate fears of combination? Why?
6. What is common law? Who enacts it? What is statute law? Why is it needed?
7. What is meant by revenge legislation? Why are antitrust laws so classified?
8. Describe the background of the Sherman Act. Account for its legislative history.
9. Summarize the results of the first two decades under the Sherman Act.
10. What characterized the attitude of the Supreme Court in interpreting the Sherman Act in 1912 and the following years?
11. What is the significance of the Harlan dissent?
12. What were the dissolution experiences under decrees by the Supreme Court?
13. What amendments to the Sherman Act were passed in 1914?
14. What are consent decrees? Why should either the government or business corporations be interested in them?
15. What were the results of the decision of the court in the trade association cases?
16. How did the attitude of the public toward the enforcement of the Sherman Act change? Why?
17. In what types of industries have most recent combinations been effected?
18. Does the public favor or oppose integration of industry?
19. What is likely to be the road ahead? How may international complications influence the answer to this question?

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**SUBJECTS FOR INVESTIGATION**

1. Read the Sherman Act. Assuming that you are an intelligent foreigner, with a good knowledge of English but without an acquaintance with our economic history, what would this law mean to you?
2. What is the most recent Federal law showing the attitude of Congress toward industrial combinations?
3. What other evidence can you find to show current American attitude toward industrial combinations?

## CHAPTER XXXIX

### INVESTMENT TRUSTS AND INVESTMENT COMPANIES

**Nature.**—One type of intercorporate relationship that has had a profound effect upon both investors of funds and the financial arrangements of operating corporations in recent years is the investment trust or investment company. The two are not exactly alike, as will be developed in this chapter. Investment company is the more inclusive term. However, to avoid repetition throughout the chapter, the term investment trust will be used as if they were the same, except where differentiation is evident. Essentially it was started to meet the needs of investors. Its use in this country has had definite influence upon the financial plans of some corporations as well. The underlying principle of investment trust operation is diversification of risk. The trust collects investable surpluses of a large number of people and invests them in a diversified group of securities in order to distribute the risks involved. This principle is unquestionably sound and forms the basis of all successful financial institutions. Investment policies of banks, insurance companies, savings and loan associations, and all other financial institutions that aggregate the capital contributions of many people are founded upon the principle of diversification of risk.

**European Origin.**—While new to America until recently, investment trusts have been used in the British Isles and on the continent of Europe for many years. England had a flurry of investment trust organizations in the early part of the nineteenth century. Its history was similar to that in this country during the 1920's, discussed later in this chapter. After the failure of those trusts organized in 1825 or earlier, a second period of organization occurred around 1860. These developed a standard pattern with the following characteristics:

1. The trust is financed with shares, corresponding to our preferred and common stocks. Limited amounts of debentures are used also.
2. The funds of the trust are invested in a manner to give the investor the advantages of diversification according to geographical distribution, industrial and governmental groupings, and types of security.
3. All managerial responsibility is avoided, and no attempt is made to control the corporations whose securities are purchased.
4. In addition to careful selection of securities for the trust's portfolio, it exercises continued supervision over the capital contributions entrusted to it.

5. The management of the trust attempts to secure for the purchasers of its securities a higher yield than they would be able to secure from similar commitments on their own account. The sources of the additional yield are careful selection of investments, profits from investments, margins resulting from trading on the equity, and income on reserve accumulations.

**Early American Experience.**<sup>1</sup>—The Securities and Exchange Commission lists 40 companies, organized in this country prior to 1921, which it classifies as investment companies. Most of them had disappeared by that date. Only a part of them would classify under most modern definitions of investment trusts. Most of them had other characteristics, and none of them were very large. As the commission reports, they had dissimilar origins and “varied widely in type of sponsorship, purposes to be served, and structure.”

**Causes of Growth after 1921.**—After 1921, American investment trusts grew rapidly until the climactic crash in the securities market in 1929. The phenomenal growth of American trusts can be traced to very definite causes. In the first place, more people than ever before had investable surpluses from which they were anxious to secure advantages. The long period of prosperity during the 1920's, with its high incomes, created hordes of new capitalists with no experience in investment and security purchases. This new army of investors wanted not only safety of investment, but high yield and an opportunity for appreciation of their principal. Channels for the purchase of corporate securities were numerous and increasing. In fact, the array of stocks and bonds was so extensive and so alluring that the new capitalists became confused and hesitated to trust their own judgment in making capital commitments. Coupled with this confusing array of investment opportunities was a boiling security market which broke all records in volume, tempo, and altitude. Even seasoned security purchasers, who sold out when prices rose to unbelievable heights, witnessed even higher new levels reached by stocks that they had sold. It is no wonder that investment “experts,” who came into such a market with a formula for ensuring safety of principal, high yield, and appreciation of principal found a ready market for their wares.

**Second Period.**—The period from 1921 through 1926 represents the incubation stage of the growth of investment trusts that was to follow. During this period, 139 new trusts were organized. The financial press began to give increasing space to a discussion of investment trust activities. Soon other publications, including family magazines with national circulation, began to discuss the new investment medium. Many of these articles emphasized the “scientific nature” of the investment of funds. It was easy for the sponsor of a trust to give the impression that he possessed the know-

<sup>1</sup> Much of the factual material of this chapter, including a few direct quotations, is taken from the reports of the Securities and Exchange Commission on “Investment Trusts and Investment Companies,” published in 1939 and the following years.



how required for scientific investment. Without any capital of his own and without any regulatory authority to check his plans, he could start a trust provided he could interest capitalists in entrusting their funds to his care. Presently, established business concerns such as investment bankers, brokers, security distributors, and investment counselors saw the opportunity for profit in the new field of finance. Even commercial banks, finding the demand for commercial loans not up to their expectations, began to form investment trust affiliates as a means of staying in business. Legal restrictions discouraged commercial banks from engaging in investment banking activities. To avoid the consequences of these restrictions, many commercial banks formed security affiliates which frequently became investment companies. The sphere of activity of these affiliates covered:

the wholesaling and retailing of security issues; serving as holding and finance companies in carrying blocks of securities, for control or otherwise, which the bank could or would not list among its own investments; assuming such loans and investments of the parent bank which might prove doubtful and nonliquid; supporting the market in the bank's own stock; and finally acting as investment companies in buying and selling securities for investment or speculative purposes.

These affiliates became major factors in the investment company development. By the end of 1926, the total assets of active investment trusts was approximately \$1,000,000,000.

**Third Period.**—With the stage set and an audience ready to pay its price of admission, American investment trusts forged ahead rapidly after 1926. By the end of 1927, total assets were nearly double those at the end of 1926. By the time of the financial crash of 1929, trusts had total assets of approximately \$7,000,000,000. The subsequent shrinkage carried this total down to \$2,800,000,000 by the end of 1932, with a recovery to \$4,500,000,000 by the end of 1936. The progress of trust organization and disappearance within this period is shown in the table on page 691.

**Types of Investment Companies.**—Investment companies can be divided into several classes, dependent upon the nature of the classification. The most commonly accepted classification includes the following types:

1. Management investment companies.
2. Fixed or semifixed investment trusts.
3. Installment investment plans.
4. Companies issuing face-amount installment certificates.
5. Common or commingled trust funds.

The following discussion sets forth the salient features of each type.

**Management Investment Companies.**—In this kind of operation usually no restrictions are placed upon the amount of discretion exercised by the management with respect to the nature, type, and amount of securities to be purchased or sold. Even where there are limited restrictions, the manage-

ment may operate freely within the circumscribed area. Sometimes the charters confine the field of operations to a specialized industry such as insurance, oil, or mining; or requirements may be placed that securities to be purchased be dividend payers, have been outstanding for a prescribed period of time, etc. Restricted management companies are relatively unimportant in number.

Management companies may confine their purchases to diversified securities without any attempt to exercise any control over the companies whose shares they hold. These are popularly known as investment trusts,

INVESTMENT TRUSTS

Year	Number active at beginning of year	Number organized during year	Number becoming inactive during year	Number active at close of year
1927	161	140	6	295
1928	295	186	26	455
1929	455	265	43	677
1930	677	131	80	728
1931	728	81	98	711
1932	711	81	102	690
1933	690	43	63	670
1934	670	25	47	648
1935	648	44	87	605
1936	605	26	72	599

whatever their form of organization. Or they may concentrate their holdings into a few blocks of securities where, by owning 10 to 15 per cent of the outstanding stock, they can have potential control over the companies whose stocks they own.

With respect to the right of the investor to present his holdings for redemption, management companies are classified as either "closed-end" or "open-end." As the name suggests, the open-end company may increase its holdings by the purchase of additional securities as its cash resources increase, or decrease them as the demands for redemption are presented. Its own securities usually sell at the net asset value of its shares, plus a loading charge of 5 to 10 per cent. A holder of its securities has the right, upon proper notice, to require the company to redeem his holdings, usually at their net asset value less, in many cases, a redemption fee varying from 1 to 3 per cent. Open-end companies seldom issue bonds or preferred stock and confine their purchases to small blocks of readily marketable securities. Holders of securities of closed-end companies must look to the open market for the sale of their holdings, since such companies do not obligate themselves to redeem the securities they issue.

**Capital Structure.**—Management investment companies are usually divided into “leverage” and “nonleverage” companies. The latter has only one class of security outstanding, usually common stock. Leverage companies have a more complex capital structure, with senior securities having fixed maximum participation in assets and earnings in addition to common stock. Any increase or decrease in the assets or earning power of a leverage company—other than that due to the investment of new capital funds—will be reflected in the equity of the common stockholders. For example, suppose that a company has outstanding \$1,000,000 in bonds or debentures, \$1,000,000 in preferred stock, and \$1,000,000 in common stock. Suppose that the market value of its holdings increases \$1,000,000. The common stock would double in value. If, on the other hand, the value of the company’s portfolio decreased \$1,000,000, the value of the common stock would disappear, except for speculative purposes, in the hope that values of the company’s holdings will recover. Fixed and semifixed trusts and most open-end companies are nonleverage. Most closed-end companies are of the leverage type.

**Fixed and Semifixed Trust.**—“A fixed investment trust is created under the terms of a trust indenture or agreement entered into between a corporation, usually termed the ‘depositor,’ a bank or trust company, usually designated as the ‘trustee,’ and the persons who contribute the funds of the trust, known as the ‘certificate holders,’ who are the beneficial owners of the trust property.” Fixed trusts usually have outstanding only one class of securities, known as “certificates.” Most fixed trusts deposit with the trustee a fixed amount of securities, known as a “unit.” Against this unit the trustee issues a specified number of certificates which are then sold by the depositor. Each certificate represents an undivided beneficial interest in the property of the unit. The price of the certificate is the aggregate market value of the securities constituting the unit, divided by the number of certificates issued against the unit, plus a loading charge which averages nearly 10 per cent. To this is added an annual management fee, based either upon assets or earnings of the unit. Certificate holders may usually ask for their redemption in the manner described above for open-end management trusts.

In the most rigid type of fixed trust, the management has no right of change or substitution in the portfolio except in case of consolidation, merger, reorganization, or sale of the assets of the issuing company. In more flexible plans, known as “semifixed” trusts, the management has the power of substitution in the event of such contingencies as the passing of a dividend for a specified period on securities held in the portfolio, the delisting of such securities from an exchange, or the reduction in investment ratings of holdings. Other types of relaxation may be included also. Some fixed and semifixed trusts specialize in holding securities of specified industries only, while others have a more diversified portfolio. Some trusts add unusual

distributions, such as stock dividends and split-ups to their portfolio and hence are known as the "cumulative" type; others, the "distributive" type, sell such windfalls and distribute the proceeds to the certificate holders.

**Installment Investment Plans.**—As the name suggests, the installment investment plan provides for the subscription by an investor for one or more certificates. He is then required to make regular installment payments of a stipulated sum over a period of years. A common plan calls for \$10 per month for a period of 10 years. The amounts paid in, less the fees and charges, known as the "load," are invested by the management, frequently in the shares of other investment trusts. In such cases this plan results in an investment trust upon an investment trust. Investors are subject in such cases to a double loading process. When the periodic payments have been completed, the investor is entitled to receive (1) the securities credited to his account, (2) their cash value, (3) or a continued investment to be managed by the trust. If he withdraws from the plan before the installment payments have been completed, he may suffer a reduction in principal, determined by the amount of the load charged to his account and by the market value of the securities held on his account at the time of withdrawal. Early withdrawal means a proportionately large reduction because of the load factor due to sales cost of the certificate presented for redemption.

**Face-amount Installment Certificate Plan.**—Face-amount installment certificates are contracts between the purchaser and the issuing company by which the company agrees to pay to the purchaser the face amount of the certificate upon completion of a specified number of installment payments. Prior to the maturity date of the certificate, the purchaser may demand the repayment of its surrender value. This value is determined by the amount of the load factor to be deducted from the amounts paid in. Under such plans it takes 4 to 8 years to recover the amounts paid in, without any credit of earnings thereon. In effect the certificate holder is in the position of a general creditor of the company which issues the certificate. Some certificates have carried annuity features so far as the repayment plans after maturity are concerned. One such plan contained an insurance feature that provided for the payment by a legal reserve life insurance company of any remaining installments to be paid after the death of the certificate holder.

**Common or Commingled Trust Funds.**—This plan is not available to the general public. In effect, it provides that a bank or trust company, acting as trustee for a number of small personal trusts or estates, may combine them into a larger fund for common administration. By this means a greater degree of diversification is possible. Evidence of participation in such a fund usually takes the form of certificates of beneficial interest, carrying \$100 denomination. The value of these certificates fluctuates with the market price of the fund portfolio. This value is determined at regular intervals for the purpose of establishing withdrawal allowances or the price

of new certificates to be issued when estates are increased or created. Such certificates are ordinarily nontransferable and nonassignable except under conditions set forth in the trust indenture. The trustee is compensated by the regular trustee's fee. In addition, an entrance fee and a withdrawal fee are charged.

**Popularity of Trust Securities.**—As already indicated above, in characteristic American fashion, investors in the securities of new investment trusts in the late 1920's rushed to buy their offerings, without stopping to enquire whether the particular trust, whose securities they purchased, was based soundly upon the principle of diversification. Nor did they try to determine whether the managers of the trust had the capacity to give the principle effectiveness. One of the severest critics of American investment trusts, as we have experienced them, analyzes their popularity in the following terms:

The average man who puts his money into an investment trust is induced to do so upon the following assumptions: that he has money to buy stocks with; that he knows there are good stocks and bad ones; that he also knows that he is not equipped to decide which are good and which are bad; that he wants to be sure to get his money into good stocks; that he knows some industries are destined to grow and others to dwindle; that he would like to invest his money in those which will grow; that he would like also to spread his investment over a large number of stocks so as to reduce the risk which always threatens eggs in a single basket; that his funds are too small to be thus spread out; that he will therefore put his money into an investment trust managed by men who are trained experts in investments, who will know how to choose his investments with prudence and wisdom, and who can be depended upon to see that he gets the benefit of the profits arising from expert management.<sup>1</sup>

**Capital Contributions.**—For the most part, investment companies and investment trusts invested their assets in the security issues of large, well-established corporations. Only a small percentage of the funds collected from the public purchased new securities, and even then not all of such funds were used to increase either the working capital or the fixed assets of American industry. Those investment companies which participated in underwriting new issues are exceptions. Such participation was not common after 1929 and was not very general up to that year.

The place where investment companies could make a signal contribution to our economy is in the field of supplying both equity capital and long-term credit to small business enterprises and to new ventures. To date, such contributions have not been large. The same doubts that deter the owner of capital from making a direct commitment for this purpose prevent investment companies from committing the funds entrusted to their care to unseasoned investment opportunities. Similar reasoning applies to the

<sup>1</sup> Flynn, John T., "Investment Trusts Gone Wrong" (New York, 1930), pp. 55-56.

participation of investment companies in reorganization procedures. Some of the reorganization participations of the past have not been very savory.

**Service to Investors**—The investigations of investment companies and investment trusts by the Securities and Exchange Commission produced results that are not very flattering to our experience with these institutions to date. For the period from 1927 to 1935, the investigation of the experiences of over 1,000 companies showed capital losses to investors ranging from 8.6 per cent for companies issuing face amount installment certificates, to 50.1 per cent for the smaller, miscellaneous management companies. The recorded capital loss for all management companies was 38.3 per cent, and for all companies studied, 37.0 per cent. Even admitting a considerable margin of error, the results are still discouraging.

"Aside from these capital losses, investors in the securities of investment companies and trusts have received a current income of less than 3 per cent per year on their investments."<sup>1</sup> In other words, for the period from 1927 to 1939, the purchasers of the securities of investment trusts and investment companies, as a class, would have been better served by the ownership of government bonds; or by leaving their funds on deposit in commercial banks, even after giving account to the proration of losses suffered on deposits in closed banks.<sup>2</sup> On the opposite side of the ledger, however, fairness compels the question: "How did the investors fare in this period who depended solely upon their own judgment in the purchase of miscellaneous securities?" While no one knows the answer, it is certain to be not very reassuring.

**Sins of the Management**.—With the bewildered security purchasers seeking substitutes for their own inadequate judgment in the commitment of their funds, it is little wonder that the managers of some trusts took pains to protect their own interests, regardless of the effects of their actions upon the purchasers of their securities. In the absence of regulation, there was little to prevent them from operating as they saw fit. Even when they kept within the existing law, they still had ample opportunity to make huge profits in ways that sound business ethics would not sanction. As early as 1924, the Board of Governors of the New York Stock Exchange warned its members that: "participation by a member of the Exchange . . . in the formation or management of investment trust corporations or similar organizations which, in the opinion of the Governing Committee, involves features which do not properly protect the interests of investors therein may be held to be an act detrimental to the interest and welfare of the Exchange."

**Proposed Regulation**.—Before the stock-market crash of 1929, various state authorities and private agencies, such as the Investment Bankers Association of America, began to consider ways and means of protecting investors against the practices of some investment trust managers and

<sup>1</sup> "Investment Trusts and Investment Companies," Part V, p. 371.

<sup>2</sup> *Ibid.*, p. 372.

against the results of their own cupidity. The attorney general of New York in reporting the results of his investigation of the subject in 1927 asserted that

1. The managers of investment trusts should be men of character, integrity, and responsibility.

2. They should have substantial investments in their own securities, as a test of their good faith.

3. Books and accounts should be properly kept, and frequent reports should be made to security holders.

In setting up what he termed rules of conduct for investment trusts, the New York attorney general proposed the following:

1. An investment trust should pay only a moderate commission—not to exceed 10 per cent—for marketing its securities. (He had discovered cases as high as 20 per cent.)

2. The primary purpose of the trust should be investment. Short sales, trading, pool operations, and market manipulation are considered to be distinctly improper activities for investment trusts.

3. Periodical audits—at least annually—should be made by certified public accountants, and a copy should be sent to all trust security holders.

4. The legality of all securities to be issued by investment trusts should be passed upon by competent legal authorities before they are sold.

5. All contingent liabilities should be advertised to prospective trust security purchasers.

6. The character of the trust and of the securities offered for sale by it should be clearly and accurately described.

7. Loans to or transactions with officers, directors, trustees, or closely affiliated companies in the purchase and sale of securities should be discouraged. The temptation to abuse the opportunity for price manipulation is considered too great for many managements to resist. Such practices should be prohibited in the articles of incorporation or the declaration of trust.

**English Experience.**—England does not undertake specific regulation of investment trusts. There trusts are organized under the English Companies Act, comparable in part to the corporation codes of American states. Certain differences should be noted, however. One Companies Act serves the United Kingdom. In the United States, 48 corporation codes sanction incorporations. The bait set by some is very inviting. Some American states make a business of incorporating companies as a substitute for taxation. England suffers from no such competition. The provisions of the English Companies Act afford greater protection to stockholders than do most of the corporation codes of American states.

**Investment Companies Act of 1940.**—In 1935, Congress directed the Securities and Exchange Commission to investigate the operation of

American investment trusts. The findings of this investigation were published in a series of volumes entitled "A Report on Investment Trusts and Trust Companies." The results not only shocked the commission, but they created a general demand for Federal regulation of investment trusts. Even the managers of some of the "good" trusts joined in this demand. Congress responded to this demand in 1940 by the passage of the Investment Companies Act and its companion, the Investment Advisers Act.

Following the pattern of the Security Act and the Securities Exchange Act, the Investment Companies Act places great emphasis upon making available to interested parties information upon which decision can be based. Managers of investment trusts who use the mails or interstate commerce are required to register with the Securities and Exchange Commission. Their applications must state their policies with respect to the kind of business in which they expect to engage, the nature of their financial plan, their underwriting operations, and other financial practices. Changes in these policies may not be made without the approval of a majority of the outstanding voting securities. As a further means of preventing changes in policies by indirection, directors must be elected by the holders of voting securities.

As of June 30, 1945, 366 companies with total assets of \$3,250,000,000 were registered with the commission.

**Management.**—In recognition of the importance of management of investment trusts, Congress prohibited those who, within 10 years, had been convicted of a felony or a misdemeanor arising out of the security business from serving as officer, director, member of advisory board, investment adviser, depositor, or principal underwriter of an investment trust. Not more than 60 per cent of the directors may be officers, employees, investment advisers, or those affiliated with investment advisers. Directors, officers, or employees of a trust may not be employed by it as a broker or principal underwriter, unless a majority of the board is not affiliated with the broker or underwriter concerned. No investment trust may obtain the majority of its directors from the official family of any one bank.

Officers, directors, and principal underwriters may neither buy securities from nor sell them to the trust. Nor may they borrow money or other property from it. Excessive commissions may not be charged by affiliated persons who act as brokers or who act as agents in the purchase and sale of the trust's property. In other words, the sections of the law which deal with management aim to provide machinery to make sure that the management works in the interest of the investors instead of themselves alone.

**Issuance of Securities.**—The Investment Companies Act provides rather elaborately for the issuance of securities by investment trusts. The conditions under which bonds and preferred stock may be sold are set forth in detail. Even the use of warrants is strictly limited. The issuance of non-voting stock is prohibited as is also the use of fractional or multiple voting.



Preferred stockholders, voting as a class, must have the right at all times to elect two directors; if dividends are in arrears for 2 years, the preferred stockholders have their right to elect a majority of the board. If the value of the assets declines to an amount less than the face value of its bonds, bondholders must be given the right to elect a majority of the board of directors.

Dividends can be paid only out of the company's "accumulated undistributed net income, determined in accordance with good accounting practice and not including profits or losses realized upon the sale of securities or other properties"; or from the "company's net income for the current or preceding fiscal year": "unless such payment is accompanied by a written statement which adequately discloses the source or sources of such payment." Dividends on preferred stock must be cumulative. No dividends (other than stock dividends) may be paid on preferred stock whenever the company's assets are less than twice the face value of its outstanding bonds. No dividends (other than stock dividends) may be paid on common stock whenever the company's assets are less than three times the value of its outstanding bonds or less than twice the value of its outstanding preferred stock.

The methods of distributing and the conditions of repurchasing securities are set forth in the act. In general, they are so worded as to prevent discrimination among security buyers. In a similar manner, the issuance of securities under periodic payment plans is strictly controlled, including the amount of loading that may be placed upon any security purchases. Face-amount certificate companies are placed under close supervision, including the building up of reserves and the investment of funds that offset them.

**Administration.**—The Investment Companies Act is administered by the Securities and Exchange Commission. The orders of the commission are subject to review by a United States circuit court of appeals. Willful violation of the act or of the commission's rules and regulations made thereunder is punishable by fine and imprisonment. The commission may resort to the use of injunctions to prevent violations. Meantime, the court may transfer control to a trustee vested with full power to dispose of any and all of the company's assets, subject to the approval of the court. The commission is given broad powers to govern the filing of reports, accounting procedures, plans for reorganization of investment trusts, solicitation of proxies, etc. All investment trusts that use the mails or any instrumentality of interstate commerce must register under this act and accept the supervision of the commission.

**Investment Advisers Act of 1940.**—As a companion law to the Investment Company Act, Congress passed the Investment Advisers Act in the same year. An investment adviser, for the purpose of this act, means

any person who, for compensation, engages in the business of advising others, either directly or through publications or writings, as to the value of securities or as to the advisability of investing in, purchasing, or selling securities, or who, for compensation, and as a part of a regular business, issues or promulgates analyses or reports concerning securities.

All such persons who use the mails or any instrumentality of interstate commerce must register with the Securities and Exchange Commission. In doing so they must furnish detailed information about their education and experience to determine their fitness to act as advisers on investments. Persons who have been found guilty of malpractices in connection with the security business during the preceding ten years are denied registration. The commission may deny, suspend, or revoke the registration of any other person when it finds "that such denial, revocation, or suspension is in the public interest." Investment advisers are forbidden to "employ any device, scheme, or artifice to defraud any client or prospective client"; or "to engage in any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client." The penalties and the procedure for the enforcement of this act are practically the same as for the Investment Companies Act.

The business of acting as investment adviser is a relatively new one. Of the 753 registrants on the books of the commission as of June 30, 1941, only 122 had organized their business before 1930. The other 631 were organized since the stock-market crash of 1929. The oldest was organized in 1898, but only 25 were organized up to the decade of the 1920's. Approximately 65 per cent of all registrants were engaged in no other business than supplying investment advice. The others indicated a variety of affiliations, with brokers, underwriters, estate managers, and publishers being the most common. As of June 30, 1945, there were 780 registrants.

About one-third charge an annual fee of one-half of 1 per cent of the value of the funds supervised. Nearly another third charge a flat fee, averaging \$25 per day for their services. Some charge an annual fee varying from \$100 to \$500 per client. Where a publication is sold by the adviser, the compensation is usually in the form of a subscription for the publication. Some are as low as \$5 per month. In some cases the compensation is determined as a matter of bargaining, with a presumption that the amount of work involved will measure the fee.<sup>1</sup>

**Appraisal.**—These two acts recognize quite frankly that the average investor is incompetent to manage his own affairs. While these laws make no pretense of correcting this weakness, they at least put obstacles in the paths of those who would take unfair advantage of investor incompetence by the use of fraud and deceit. Like the Securities Act of 1933, one of the

<sup>1</sup>Seventh Annual Report of the Securities and Exchange Commission" (Washington, 1941), pp. 33-35.

services that will be rendered to investors by the two acts discussed in this chapter will be negative in character. Under any attempt to administer these acts fairly and firmly, some individuals will be discouraged from attempting to register as investment advisers or from attempting to manage investment trusts. At least those whose records are blackest will be kept out of the field of trying to attract the favor of thrifty people with investable surpluses.

**The Need.**—Anyone who has had occasion to talk with various classes of people about investment policies and programs will gain little comfort from their capacity for dealing with the simplest problems of investing money. Even business executives, successful in their own lines of production and distribution, frequently become babes in the woods when confronted with the problems of investing funds not needed in their business enterprises. In the face of what appears to be general investment incompetence, we must admit increasing complications in organized demand for capital. Local business units may be absorbed by large corporations with national and even international connections. Political, social, and economic philosophies help to determine the integrity of capital commitments. A war or a change in political and economic control of one country may affect investments in another part of the world, and in ways most indirect.

Publicity and education cannot be expected to make an investment analyst of every owner of capital. The best that we can hope for from these quarters is a realization on the part of most investors of their own incompetence, unaided by sound advice. The need for organized investment service is great. The fundamental principles upon which competently managed investment trusts are based go far toward meeting this need. Diversification, expert management, and consistent watchfulness for changes in economic, social, and political conditions that may adversely affect the integrity of some investments are all essential characteristics of a sound investment policy. Individual investors usually do not have the time, the capacity, or the inclination to do the work necessary to arrive at sound investment conclusions.

**Evolution.**—Perhaps the unfortunate experiences which many American investors have had with investment trusts to date merely illustrate the price that a vigorous new country with large resources is usually asked to pay for experimentation with any new economic proposal. In contrast to common opinion of conservatively managed British trusts, many of those that we have tried out to date do not leave a favorable impression. Let it be recorded, however, that the early history of British trusts has much in common with the 1920's experience with our trusts. From the ashes of early failures, British investment trust managers erected new and more stable institutions for conserving the investable surpluses of small capitalists. We too may be able to learn from experience to discriminate among those who

bid for control of our capital funds and to recognize that the name "investment trust" does not qualify every institution that uses it to represent properly the interests of investors in its securities.

### QUESTIONS AND SUGGESTIONS

1. What is the basic principle of investment trust organization?
2. Where did investment trusts originate? What were the characteristics of the early English trusts?
3. What caused the growth of investment trusts in this country after 1921?
4. What were the characteristics of the second period of American investment trusts?
5. How did commercial banks become interested in the formation of investment trusts?
6. How large an amount of money was entrusted to these institutions in the third period?
7. What are management investment companies? Differentiate between closed-end and open-end companies.
8. Distinguish between leverage and nonleverage companies.
9. What is a fixed trust? How does it differ from a semifixed trust?
10. How do the cumulative type of trusts differ from the distributive?
11. Describe installment investment plans. What happens when all installments have been paid?
12. Describe the face-amount installment certificate plan. How does the surrender value compare with the amounts paid in? Why?
13. What is the commingled trust plan? What are its advantages?
14. What has been the over-all experience with American trusts in serving investors?
15. Why was it possible for unscrupulous managements to take advantage of the purchasers of trust securities?
16. What early proposals were made for regulating investment trusts?
17. How does England regulate investment trusts?
18. What caused the demand for Federal regulation in this country? How does the Investment Companies Act of 1940 attempt to deal with management? How does it deal with the issuance of securities?
19. Describe the Investment Advisers Act of 1940.
20. Why is there a need for the investment trust type of financial organization in this country?

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**SUBJECTS FOR INVESTIGATION**

1. From the reports of the Securities and Exchange Commission or from any other available source, find what current practices are in investing funds in investment trusts.

2. Study the portfolio of an investment trust, and appraise the amount of diversification that you find therein.

3. From the reports of the Securities and Exchange Commission or from other sources, tell how effective you think the regulation of investment trusts has been to date.

## PART VI

# CORPORATE READJUSTMENTS

### CHAPTER XL

#### CAPITAL READJUSTMENTS OF SOLVENT CORPORATIONS

**Scope of Chapter.**—By a solvent corporation is meant one whose assets are at least equal in value to its liabilities. Presumably, if the corporation were forced to liquidate its assets in order to pay its debts, it could do so. Meantime, however, it may find itself in a position in which it has great difficulty in meeting all its obligations on their due date. Furthermore, if its managers plan to continue its operation, they think in terms of a going concern rather than in terms of using the assets to liquidate the liabilities. Changes in the capital structure may be sought as a means of easing the tension and giving the corporation a better opportunity to pursue its purposes. The changes discussed in this chapter are of this character. Changes due to the eminent success of the corporation were discussed in the chapters on expansion. Changes due to corporate failures will be taken up in succeeding chapters. The causes for readjustments in the capital structures of solvent corporations are numerous. The more common are included in this chapter.

**Unbalanced Financial Plan.**—Financing in the past may have been so timed or conducted that the corporation has become top-heavy with bonds, the carrying charges on which place heavy burdens upon the operations of the corporation. Such financing seems unavoidable when corporations purchase new capital in markets that insist upon bond issues and will not become interested in stocks. Such corporations may take advantage of more favorable financial markets and redeem their bonds from the proceeds of the sale of stock. Every bull market finds many corporations issuing new stock for the purpose of ridding themselves of the burdens that bonds place upon them. Even preferred-stock issues are retired if common stock can be sold to advantage.

The readjustments that result from creating a better balanced financial plan are more or less routine in character. The corporate managements simply take advantage of the privileges granted them in their security contracts to replace one issue with another whenever the market is favorable.

Unlike some other types of readjustment, there is no occasion to consult anyone about the changes, since no one is asked to give up rights or modify contracts. The motivating force is the desire of the management, coupled with a favorable set of circumstances for making this desire effective. As indicated in the chapter on railroad finance, the managers of strong railroad corporations did not see fit to retire their funded debt during the decade of the 1920's when at least some of them could probably have done so. Managers of industrial corporations, on the other hand, frequently did so.

**Reducing Fixed Charges.**—When a corporation has been forced to issue bonds carrying a high rate of interest, as, for instance, in refunding a bond issue that falls due during a tight money market, it may be able at a more favorable time to refund its bonds again, this time before maturity and at a considerable saving in interest charges. To make the latter refunding possible, the bonds to be retired should be callable. In some cases, the refunding is only partial, stock or accumulated earnings being used to redeem a part of the bond issue that is retired. Here again no one need be consulted, and no contractual arrangements need be changed. If the corporation calls a bond issue, it merely takes advantage of a right granted at the time the bonds are issued. If it reduces fixed charges by some other method, such as the purchase of its bonds in the open market with its surplus cash, it buys only such as the bondholders are willing to sell.

**Bond Extensions.**—By contrast with the foregoing readjustments, bond extensions are made possible by the willingness of bondholders to postpone the maturity date of their contracts with the corporation. Usually, individual bondholders are uninformed, disorganized, and more or less bewildered when they are faced with a request of this kind. Their choices are usually limited to an expressed or a tacit consent. They would not know how to go about the enforcement of their original contract. They may be asked merely to extend the due date of the bonds. Dependent upon their strategic position, they may or may not be asked to make sacrifices other than the extension of the maturity date of the bonds.

**Interest Adjustments.**—Bondholders are sometimes asked to accept interest adjustments without extending the term of their bonds. These may be in the nature of decreases or deferments of all or a part of current payments.

In 1934, the Advance Bag and Paper Co., Inc., made an agreement with the holders of its first mortgage sinking-fund gold 6s whereby interest coupons, due 1933, were paid at one-fourth of face value; 1934 coupons were stamped to be paid at one-third; 1935 coupons at one-half; and 1936 coupons at three-fourths. The company's 10-year scrip, redeemable on or before 1943, with interest at 6 per cent, was issued in an amount representing the difference between the coupons paid and that agreed to be paid. Adjustments were made also in the sinking-fund requirements on these bonds.

**Funding Current Obligations.**—At times, corporations become embarrassed by large amounts of current obligations. Their assets may be ample to protect their creditors, but they may be in such form that they cannot be easily liquidated to pay current obligations. Furthermore, their liquidation is not desired by the corporation, since their use is necessary to the future operations of the corporation. When current obligations become larger than current collections, it may be necessary for the corporation to issue stocks or bonds, using the proceeds to pay off the current indebtedness. Under the circumstances assumed, it appears that the investment represented by the current obligations is permanent. Therefore, there is every reason for funding the obligations instead of carrying them as current indebtedness, however patient the creditors may be about demanding settlement of their claims. Corporations can take advantage of favorable financial markets to readjust their financial plans to meet the new conditions arising from their overload of current obligations.

Examples of recent funding of current obligations are the following cases. The Schenley Distillers Corp. issued \$17,625,000 5½ per cent cumulative preferred stock to retire bank loans, increase working capital, and enlarge and improve its manufacturing and warehousing facilities. The United Gas Improvement Co. used the proceeds from the sale of 250,000 shares of \$5 no-par, nonvoting preferred stock to retire its floating debt and to provide additional circulating capital.

**Funding Accumulated Dividends.**—Unpaid cumulative dividends on preferred stock do not constitute debts of the corporation, and, if they are never paid, the preferred stockholders can not force action thereon so long as boards of directors act in good faith. But such accumulation of dividends stands in the way of dividends on the common stock. Before any distribution can be made to the latter, the accumulation of preferred dividends must be eliminated. As a general rule, payment of large accumulations in cash is out of the question. Even a very successful corporation would consume a long time in paying off large accumulations. Consequently, directors usually make some sort of deal with preferred stockholders, promising them immediate resumption of cash dividends at the stipulated rate, provided that they agree to the funding of accumulated dividends in the form recommended to them. The funding of dividends may take the form of debenture bonds, second preferred stock, new preferred stock of the same kind as that already outstanding, or even common stock. It is not uncommon to give the preferred stockholders some part of their dividend accumulation in the form of cash as a further inducement to encourage acceptance of a refunding plan.

In some cases only the accumulated dividend is funded, with no change in the stock itself. In other cases the character of the outstanding stock is changed as a part of the refunding process. The following table includes



## EXCHANGE OF PREFERRED STOCK AND ACCUMULATED DIVIDENDS

Name of company	Rate on old preferred	Amount of arrears	Securities received	Cash received per share, old preferred
Abercrombie and Fitch Co. . . . .	7	\$ 35	1½ shares 6 per cent preferred (\$75) and ½ common	\$15.08
Amalgamated Leather Co., Inc. . . . .	7	105.25	1 share 6 per cent preferred and 5 common	None
American Hide and Leather Co. . . . .	7	217.75	1 share 6 per cent preferred (\$50) and 4 common	None
Armour and Co. . . . .	8	25.50	1.34 shares 6 per cent preferred; or 1 share 8 per cent preferred, 0.24 share 6 per cent preferred	1.50
	6	19.12½	1.18 shares 6 per cent preferred	1 12½
	5½	16.87½	1.16 shares 6 per cent preferred	0.87½
Ayre Associates, Inc. . . . .	\$7	44	1 share \$7 preferred (\$9) and 5 common	None
Barker Brothers Corp. . . . .	6½	30.87½	2½ shares 5½ per cent preferred (\$50) and 1 common	10
Bethlehem Steel Corp. . . . .	7	21	1 share 7 per cent preferred and 1 share 5 per cent preferred (\$20)	1
Bucyrus-Erie Co. . . . .	7	16	1 share 7 per cent preferred and 1 common	5
Certainfeed Products Corp. . . . .	7	57.95	1.7 shares 6 per cent prior preferred or 1 prior preferred and 5 common	None
Cooper-Bessemer Corp. . . . .	\$3	16.50	1 share \$3 prior preference and 0.6 share common	0.50
Fairbanks, Morse, and Co. . . . .	7	25	1 share 6 per cent preferred and 1 common	2
Gimbel Brothers, Inc. . . . .	7	25	1.25 shares \$6 preferred	None
Goodyear Tire and Rubber Co. . . . .	7	14.25	1 share \$5 preferred and common	None
Hartman Tobacco Co. . . . .	6½	47.75	1 share \$4 cumulative prior preference, 1 share \$3 noncumulative preference, and 2 common	4
Kaheis (E.) Sons Co. . . . .	Class A participating	12.80	2½ shares common	6.78
Kellogg Switchboard and Supply Co. . . . .	7	57.75	1 share \$5 preferred and 5 common	7.75
Mangel Stores Corp. . . . .	6½	39	1 share \$5 preferred and 3 common	5
Otis Steel Co. . . . .	7	36.75	1.28 shares \$5.50 preferred and ½ common	None
Oxford Paper Co. . . . .	6	27	1.25 shares 5 per cent preferred and 1½ common	2
Remington Arms Co., Inc. . . . .	7	32.02	1 share 6 per cent preferred and 10 common	None
Skenandoa Rayon Corp. . . . .	\$7	45.50	1.4 shares 5 per cent preferred	5.50

cases in which the stock changed form along with the funding of the accumulated dividends.

**Reduced Preferred Dividends.**—Even where there is no accumulation of dividends on preferred stock, many corporations take advantage of favorable money markets to reduce the dividend rates on their preferred stock. While in form the old stock is called and new stock is sold to obtain the funds to redeem the old stock, in fact the refunding is frequently accomplished by an exchange of new stock for old. Sometimes a small bonus is offered as an inducement to effect the exchange. The following table shows illustrations of exchanges to reduce dividends on preferred stock.

EXCHANGE OF PREFERRED STOCK TO REDUCE DIVIDENDS

Name of company	Outstanding rate	Exchanged for preferred with dividend of	Ratio
Beatrice Creamery Co. . . . .	7 per cent	5 per cent	1 to 1
Dow Chemical Co. . . . .	7 per cent	5 per cent	1 to 1
Endicott-Johnson Corp. . . . .	7 per cent	5 per cent	1 to 1
Fishman Co. . . . .	7 per cent	5 per cent	10 to 11
Gardner-Denver Co. . . . .	7 per cent (\$100)	\$3 (\$20)	1 to 1 $\frac{2}{3}$
General Machinery Corp. . . . .	7 per cent	4 $\frac{1}{2}$ per cent	1 to 1.05
Halle Bros. Co. . . . .	6 $\frac{1}{2}$ per cent (\$50)	\$2.40	1 to 1
International Milling Co. . . . .	6 and 7 per cent	5 per cent	1 to 1
Jantzen Knitting Mills. . . . .	7 per cent	5 per cent	1 to 1
M. A. Hanna Co. . . . .	7 per cent	\$5	1 to 1.05
Patterson-Sargent Co. . . . .	7 per cent	4 per cent	1 to 1
Radio Corporation of America. . .	\$5 (Class B)	\$3.50	Bonus, 1 common
Tide Water Associated Oil Co. . .	6 per cent	\$4.50	Bonus, \$2
United States Potash Co. . . . .	10 per cent	6 per cent	1 to 1.05

**Frozen Assets.**—Circulating capital is expected to be in liquid form; otherwise it cannot circulate. A corporation may have large inventories and carry large amounts of receivables and yet be greatly embarrassed in its current operations. Using a liberal credit policy, a corporation may easily sell itself out of business. Or, following a desire to take advantage of low material prices, it may speculate itself out of business. That is, its inventories and/or receivables may absorb its cash and credit and leave further operations crippled until receivables can be collected or inventories converted into cash. In effect, such corporations have added to their manufacturing and selling problems the necessity for financing receivables and inventories. This situation may be met by a readjustment of the financial plan of the corporation through the issue of stocks or bonds. Short-term borrowing against frozen assets is commonly used but has limitations, for

the conditions that create frozen assets are not conducive to liberal loans from banks. Neither do they speak strongly in favor of stock issues. At times, only bonds can be issued even by the strongest of corporations. These may be refunded into stock in more favorable financial markets or redeemed as soon as the frozen assets are liquidated, should such action be deemed desirable.

**Capitalizing Surplus.**—Stock dividends result in more or less permanent capitalization of that part of the surplus that is so distributed. This process changes the style of the financial plan but otherwise does not affect either assets or liabilities. It merely crystallizes the interest of the stockholder in the surplus account. Bond dividends, if used, would also capitalize the surplus but would create corporate indebtedness that affects the interests of creditors as well. Reduction of stated capital to bolster up a depleted surplus account would reverse the process and result in “uncapitalization.” Capitalizing of surplus serves also to effect better balances between preferred and common stock and between stocks and bonds. Balancing the financial plan by this means may make new bond issues possible where, without such capitalization of surplus, bankers might hesitate to undertake the sale of new bond issues because of the already large proportion of bonds to stocks.

**Simplifying Corporate Structures.**—The use of the holding company device with numerous subsidiaries, some of which are organized to serve specific purposes that have only limited life, complicates financial structures and even handicaps operations at times. For instance, a subsidiary whose products have successfully passed through the experimental stages might have greater difficulty in marketing its products than would its parent company, whose good will alone would attract many customers. For this and other reasons, corporate managers may find simplification of complex corporate structures desirable. This process may result in the elimination not only of the subsidiaries but also of the holding company in favor of an operating company.

Since 1922, the Associated Gas and Electric Co. has merged, dissolved, rendered inactive, or otherwise disposed of 343 subsidiaries. In the 3 years ending in 1936, the Cities Service Co. merged and consolidated 91 subsidiaries. During the past several years, the Commonwealth and Southern Corp. has eliminated more than 120 subsidiaries and intermediate holding companies through consolidation.

**Simplifying Financial Plan.**—In issuing a call to retire some of its outstanding bonds, Armour and Co. (Illinois) made the following announcement in justification of its action:

This is another step in the program directed toward simplifying the company's capital structure. Existing laws discourage involved corporate structures such as were necessary and desirable in the past. Recently we liquidated the North American Provision Company, a wholly owned subsidiary, and the J. K. Mosser

with four wholly owned subsidiaries into the Bethlehem Steel Corp. of Delaware, organized in 1919, to form a new parent company. Ten additional subsidiaries were merged or dissolved during 1936.

**Matching Equities.**—When two corporations are about to be combined in a merger or a consolidation, preliminary readjustment of the capital account of one of them may facilitate exchanges of stock. Share-for-share exchanges are more easily understood by, and therefore more acceptable to, some stockholders than are fractional trades. Exchanges can be facilitated at times by readjusting the capital account of one of the corporations by either an increase or a decrease in the amount of the capital stock outstanding.

**Refinancing Preliminaries.**—When a corporation desires to effect a major refinancing program, such as the sale of a large new bond issue, it may find obstacles in the form of small closed issues already outstanding. Before the larger program can be undertaken, it may be necessary to get rid of the small bond issue. Stock may be sold to acquire funds for this purpose, or surplus cash may be used temporarily, since the treasury can be reimbursed from the proceeds of the sale of the larger issue.

**Segregation of Assets by Judicial Decree.**—Corporations organized in violation of antitrust laws are sometimes forced to dissolve. This requires readjustments in capital accounts and even the creation of new corporate units or re-creation of those which were combined to form the unit attacked by the court. Segregation of assets by Interstate Commerce Commission ruling in the case of some railroads has, from time to time, brought about changes in financial plans. Since the organization of the Federal Trade Commission, it has had general supervision over dissolution plans of corporations convicted of violation of antitrust laws.

**Stock Split-ups.**—One kind of readjustment in the financial plans of solvent corporations has for its purpose the control of the price ranges for the stock on the open market. For example, when the price of a stock goes up too much in a bull market, it gets out of the speculative zone. Speculators and even investors lose interest in it. Under these circumstances, it is a simple matter to split up each share into as many new shares as are desired by the management. The prices of the new shares will fall to approximately the level of the stock before the split divided by the number of shares into which the old stock is divided. If, on the other hand, the stock is already in the "cat-and-dog" class—selling at too low a price to attract the desired market interest—it is again a simple matter to combine existing shares into a smaller number of new shares. This process is sometimes called a "reverse split." Its effect is to raise the price of the stock by an amount approximately equal to the old price multiplied by the number of shares combined to form a new share.

A good illustration of both actions is shown by the successive experiences of the General Motors Corp. In 1920, its common stock was selling at

about \$400 per share. The management split the stock 10 for 1 and changed it from \$100 par to no-par. The immediate effect was to bring down the price to approximately \$40 per share. Soon afterward, the stock market generally declined to a level that carried General Motors stock down to approximately \$15 per share. This brought it within the "cat-and-dog" class. The company then called in the old stock and issued in its place 1 share for 4, again bringing the stock back to the desired price zone. With improved prices later in the 1920's, General Motors split its stock 2 for 1 in 1927, and subsequently split the new shares 2½ for 1 in 1929. All these actions were consistent with the desire of the management to keep the shares of its corporation within the price zone that was considered most attractive to security purchasers.

**Tax Adjustments.**—Various financial adjustments are made to evade tax payments. One was presented by the Western Union Telegraph Co. to its lessor companies in 1944. Since the courts had ruled that rentals paid by the Western Union represented taxable income to the lessors, the lessee proposed to exchange its 4 per cent debenture bonds for the stock of the lessor companies, at ratios varying from \$17 to \$130 in bonds for each share of stock. By this means the tax on the income of the lessors would be eliminated. Incidentally, the interest on the debentures was to be somewhat less than the existing rental payments. This plan was not accepted by the stockholders of the lessor companies.

Method	Number of corporations	Percentage distribution
No-par stated value reduced . . . . .	219	33
Par value reduced . . . . .	180	27
No-par changed to par . . . . .	170	25
Par value changed to no-par . . . . .	75	11
Number of shares reduced . . . . .	29	4
Total . . . . .	673	100

**Write-downs.**—In the same manner that a stock split-up is evidence of business prosperity and rising stock prices, a capital stock write-down usually accompanies business depression and falling stock prices. For the period from 1930 to 1937, one extensive study of the subject found that 15 per cent of approximately 4,000 corporations investigated practiced capital stock write-downs in some form.<sup>1</sup> The methods used to write down the stock were as listed in the above table.

<sup>1</sup> Much of the material on this subject is taken from an unpublished dissertation submitted in partial fulfillment of the requirements for the Ph.D. degree at Ohio State University in 1939 by R. E. Glos, under the title "Capital Stock Write-downs."

The book value of the stocks before the write-down amounted to approximately \$7,500,000,000. The amount of the write-down for all companies combined was nearly 60 per cent, with the greatest number of companies writing down their stock exactly half. In approximately 11 per cent of the cases studied, preferred stock as well as common was written down. The disposition of the amounts written down is shown in the following table:

Disposition	Percentage Distribution
To surplus .....	34
Write-off of tangible assets .....	24
Write-off of intangible assets .....	19
Eliminate deficits and losses .....	15
Reduction of investments .....	4
Miscellaneous .....	4
Total .....	<u>100</u>

The surplus item was sometimes designated as "capital surplus," although "paid-in surplus," "reduction surplus," and just "surplus" were also commonly used. In a great many instances the amount of the write-down was distributed over a variety of uses, sometimes as many as 15 in a single corporation.

The reasons for capital stock write-downs were classified as follows:

Reason	Number of Write-downs
Write-off of deficits and losses .....	305
Write-off of tangible assets .....	251
Write-off of intangibles .....	131
Eliminate or reduce preferred stock and dividend arrears thereon ..	72
Save taxes .....	53
Reduce book value of investments .....	41

In other words, in approximately half the cases studied, the write-down eliminated a deficit or absorbed a loss. The realistic chairman of the Oliver Farm Equipment Co. wrote his stockholders in seeking their support for a substantial capital stock write-down as follows: "The management and the board of directors feel that the large deficit should, in view of prospective moderate earnings, be recognized as a loss of capital invested rather than continue as a burden to be absorbed by future earnings." Writing-down of assets believed to be overvalued accounted for a large proportion of all write-downs. The assets so written down included land, buildings, machinery and equipment, and occasionally even receivables and inventory.

**Effects.**—The effects of the write-downs of capital stock involve both the management and the security holders. Frequently, stockholders were asked to give their consent to write-downs. This was usually not difficult to obtain.

Most stockholders knew of no better policy to follow than to accept the recommendations of their officers and directors. Once the write-down was approved, the managers of the corporation had full discretion about its disposition. By the elimination of deficits and the creation of surpluses, corporations were frequently put in a position to resume dividend distributions without restoring equities lost preceding the write-down. The president of Armour and Co. stated the case to his stockholders in the following words:

There are only two practical ways to . . . place the company in a position to pay dividends. One is to make no change in the capital structure and wait until earnings accumulate to a point where the board could feel reasonably sure that net assets were in excess of stated capital. . . . The other way is to change the capital structure by reducing stated capital and writing down the book values of assets appropriately out of paid-in surplus resulting from such reduction. Since at the present rate of earnings it would take many years to get to a place where dividends could be paid if no such change were made in the capital structure, the board of directors is recommending such a change.

**Security Holders.**—It is pertinent to inquire at this point how the write-downs actually affected the various classes of security holders. Nearly all states have enacted legislation to limit capital stock write-downs in such a way that the interests of creditors shall be protected. While, as a result of the elimination of a deficit, a corporation is enabled to pay dividends more quickly from future earnings, no evidence was found to prove that bondholders suffered losses as a result of the early resumption of dividends. It must be kept in mind, however, that the period covered by this study ended in 1937. Subsequent actions of corporate directors might result unfavorably for bondholders.

Except in those cases where relationships among classes of stock were disturbed, stockholders benefited from write-downs. For example, assume that there is only one class of stock in a given corporation. If a large deficit is permitted to remain on the books, the corporation's credit standing is adversely affected, no dividends can be paid, and taxes will be based upon the old stock values. By writing down the stock, all these tendencies will be reversed. Taxes will be lower, credit standing will improve, and the corporation is in a position to resume the payment of dividends, at least as soon as new earnings are realized. Meantime, the write-down does not reduce the real value of the shares or the proportion of each stockholder's interest in the corporation. It merely records the results of forces that have already been at work.

**Market Prices.**—The effects of capital stock write-downs may result in misleading those interested in the market price of the corporation's securities. Since most people judge security values quite superficially, they are likely

to be greatly influenced by current earnings per share. Suppose that a write-down of capital stock was followed by a write-down in assets. Future depreciation charges could be correspondingly reduced, with a higher per share earnings ratio without any actual improvement in earnings. Suppose also that the number of shares had been reduced in the write-down process. Again the per-share earnings would be exaggerated.

**Conclusion.**—In his concluding chapter, Glos makes the following observations:

The procedure to consummate a capital reduction is simple, and, under the proxy system of voting, is easy to negotiate with the stockholders. Almost no limitations are placed upon the use of the write-down surplus. . . . As matters now stand, any corporation can, and frequently does, alter stock values with a minimum of difficulty. Following the creation of a capital surplus, the board of directors is able to make extensive alterations in the balance sheet structure which may have long-term effects upon earnings and dividend policies. By perfectly legal means, and without any stigma, it is possible to accomplish what otherwise would involve a bankruptcy proceeding or the sale of the corporation.

### QUESTIONS AND SUGGESTIONS

1. Do solvent corporations ever experience difficulty in meeting their financial obligations? Explain.
2. What is an unbalanced financial plan? What are its causes? Its remedies?
3. What is the reason some corporations are burdened with too heavy fixed charges? What can be done about it?
4. What are bond extensions? Why are they used? What other adjustments are sometimes made in bond contracts?
5. How may current obligations be funded?
6. How are accumulated dividends on preferred stock funded? What forms do funding operations assume?
7. How may the dividend rate on preferred stock be reduced?
8. What inducements are offered to effect exchanges of old preferred stock for new?
9. What are frozen assets? How can they be thawed out?
10. By what means can a surplus be capitalized?
11. How are corporate structures simplified? Why is this practice desirable? How is the financial plan of a corporation simplified?
12. What means are used to evade taxes?
13. What is the meaning of matching equities? Why is it done?
14. Under what circumstances may judicial decrees result in capital readjustments?
15. What is the major purpose of a stock split-up?
16. What are "cat-and-dog" stocks? Mention several that could classify as such.
17. What do you think of the proposal of the Western Union Co. to its lessor companies?
18. What is a capital stock write-down, and why is it practiced? What methods are used to accomplish it? What disposition is made of the amounts written down?
19. What kinds of assets are written down?
20. What are the effects of capital stock write-downs?



## SUPPLEMENTARY READINGS

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- GRAHAM, B., and D. L. DODD: "Security Analysis" (New York: McGraw-Hill Book Company, Inc., 1940), Chap. XV.
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- SARGENT, M., and S. ZELKOWICH: The Problem of Reorganizing "Solvent" Corporations, *Illinois Law Review*, Vol. 29, pp. 137-153.
- TAYLOR, W. B.: "Financial Policies of Business Enterprise" (New York: D. Appleton-Century Company, Inc., 1942), Chap. XXXII.

## SUBJECTS FOR INVESTIGATION

1. From a recent edition of a manual find two examples of unbalanced financial plans. Why do you classify them as such?
2. Find two cases of writing down of assets. What reasons are given to justify these actions? What other possible reasons might not have been stated?
3. Find two illustrations of funding of accumulated dividends on preferred stock and show what happened in each case.

## CHAPTER XLI

### CORPORATE FAILURE

**Common Misunderstanding.**—Financial news statements frequently carry some such story as the following: "The X corporation failed yesterday." In exceedingly rare instances, this could be a statement of fact. In most cases, the admission of failure occurred at the time the failure is announced. The failure took place some time previously. Business failures are similar to failures of college students. When the latter say they "flunked" a course on examination day, what they really mean is that they failed the course during the progress of the term, at the time they enrolled in it, during their high school days, or even at the time they selected their grandparents. On only very rare occasions would it be possible for a student to fail a course on examination day. If he had the inherent capacity to do the work, had studied in high school the courses necessary to give him the proper background for the college course, and had made proper application of his time during the term in which the course was taken, he should have been able to pass the examination in question.

**Steps in Business Failure.**—So in business. Failure to meet a certain test may precipitate an announcement of failure. This is not the first step in the progress toward reconstruction, but the third. Back of it are at least two preliminary steps, more or less definitely defined.

1. The first step is actual failure. This frequently occurs at the time the enterprise is launched. Many businesses never have a chance to succeed. Owing to various causes, to be discussed later in this chapter, they are doomed to fail when their managers undertake their organization.

In other cases, failure occurs at a time subsequent to organization of the enterprise. It may result from a specific catastrophe or from a series of unfortunate events, no one of which may be blamed for the failure. In any event, business failures do not just happen. They result from causes that may not be recognized at the time but that become apparent at later periods.

2. The second step is recognition of failure. Sooner or later, the managers of most unsuccessful business ventures must recognize that their venture is headed for the rocks. Occasionally, a manager never does believe his project has lost all chance of success. He thinks himself the victim of his creditors or his competitors. For the most part, managers eventually become convinced that something is wrong. This conviction seldom comes at the exact moment of actual failure. Optimism serves as a smoke screen

to obscure the vision and shut out the views of failure to those who still have confidence in their ultimate success. Usually, however, before outsiders learn of the plight of the corporation, the managers admit to themselves that they are skating on thin ice. From then on, their actions may take any one of several turns. They may still hope for ultimate success and act accordingly, giving no hint to creditors or others that their position is precarious. They may make heroic efforts to save the situation. They may make retrenchments in the hope of salvaging as much as possible from the wreck. A bold front may be used to cover their retreat. Or a policy of watchful waiting may be adopted to see what may turn up. In 1936, the interest accumulated on the 5 per cent cumulative income bonds of the Third Avenue Ry. Co. amounted to \$502.50 per \$1,000 bond. These bonds have voting rights at the rate of one vote for each \$100. They are secured by a lien on all the company's property, subject to certain underlying liens. The accumulation of this amount of unpaid interest does not suggest successful operation. Yet it did not cause admission of failure.

3. Creditors exhibit remarkable patience. Shylocks in business are not so numerous as they are pictured. Business relations are not governed by rigid rules of legal rights but by the laws of expediency, which leave room for a great deal of give-and-take. Nevertheless, the obligations of a failed enterprise do press for settlement, after a time. Admission of inability to meet them is usually called failure. In reality, it is the third step in the failure process. The managers of the enterprise may have known for months that it was insolvent. Actual failure may have occurred months or years previous to its announcement and public admission. On the other hand, the three steps may be taken at once in case a catastrophe causes a failure, forces its recognition upon the management, and results in admission of inability to meet claims of creditors all at the same time. Blind or stubborn managers are sometimes convinced of the failure of their enterprise only when outsiders force admission upon them.

In 1935, the Brown Co. informed its bondholders of the difficulties encountered during the preceding four years—including the depression in the pulp and paper industry, increased wages, higher freight rates, higher prices for raw material, price cutting upon the collapse of the NRA, etc.—and indicated that no further interest would be paid until a capital reorganization could be effected. In other words, the company admitted failure.

**Nature of Failure.**—Failure means inability to meet obligations. It may be total or partial, temporary or permanent. In 1933, probably many of the business enterprises of the country were technically insolvent; *i.e.*, the market value of their assets *in cash* was probably less than the aggregate amount of their commitments. Hence, if they were forced to convert into cash, at once, all their assets in order to pay off immediately all their obliga-

tions, banks, insurance companies, commercial institutions, and industrial corporations would disappear in great numbers. Fortunately, businessmen recognize the dependence of business processes upon the orderly procedure of credit operations and do not look for the impossible from their debtors.

Admission of failure is sometimes used as a refuge against those creditors whose claims become embarrassing. It results in a declaration of a moratorium which gives the corporation a breathing spell needed to put its house in order. When failure is admitted, there is always a question about its extent and character which time alone can answer.

**Moratorium.**—Unless bankruptcy is definitely intended, the admission of failure is followed by a kind of moratorium giving interested parties a chance to collect their forces and determine their rights. Meantime, control of the enterprise may be placed in any one of three hands:

1. An equity receiver may be appointed. Confusion frequently results from connecting receivership and reconstruction. There is no necessary relationship between the two. Either may be present without the other. If a creditor presses his claim in an equity court, in effect the court says: "I am at present unable to determine rights and remedies in this case. Pending the receipt of necessary information, which only a careful study of the situation can supply, I will assume control of the business enterprise in question and conserve its assets in the interest of all concerned." The receiver in equity is then appointed as the agent of the court to manage the enterprise, under the direction of the court, pending final settlement of its difficulties. The receiver and the court may have no part in such final settlement.

Or a trustee may be appointed under Chap. X of the Chandler Act. This subject will be discussed in the next chapter of this text.

2. As an alternative to the equity receiver, the creditors may agree to take over the management of the business, with the consent of the present management. The latter is usually helpless unless it wishes to incur the expense of a receivership. With the consent of everybody concerned, a creditors' committee may be appointed with power to act for all creditors. It may permit officers and employees to operate the corporation, under its supervision; one or more of its own number may be designated for that purpose; or outsiders may be brought in. In any event, the creditors' committee merely takes the place of the equity court, supervising the affairs of the failed corporation pending a settlement of its difficulties.

3. A third alternative is to permit the old management to continue its control, pending the solution of its problems. If the creditors feel that the failure is due to no fault of the management, there is little point to replacing it with others unfamiliar with the operations of the enterprise. By such consent operation, no one relinquishes any rights. Creditors merely agree not to press their claims until all can be served by a settlement of the corporation's difficulties.

**Mutual Agreement Required.**—A high degree of mutual confidence is required in each of these three programs. Particularly in the case of creditors' committees and consent operation, there must be an evident willingness on the part of all concerned to go along with the voluntary program of temporary control of the business enterprise. Unless all creditors agree, creditors' committees and consent operation are impossible. Even after one plan is put into operation, it may be abandoned in favor of another. Experience with consent operation may prove unsatisfactory, and a creditors' committee may result. Change of heart on the part of one or more creditors may necessitate a receivership in equity. For cause, the latter may be dismissed, and a bankruptcy receiver, to be discussed in a later chapter, may be appointed in his place.

**Types of Settlement.**—In general, any one of three types of settlement might result from any of the three plans of operation under the moratorium.

1. Under favorable circumstances, complete recovery might result from a period of consent operation or of control by a creditors' committee or by a receiver in equity. The last is less likely to result in complete recovery than either of the two others. If the difficulties are serious enough to call for the appointment of a receiver, recovery is unlikely. On the other hand, if temporary troubles, resulting from a catastrophe or from frozen assets, for instance, can be adjusted, capable management may be able to rehabilitate the corporation, pay all obligations in full, and enjoy future success.

2. Dissolution may result from any of the three plans of temporary operation of a failed corporation. The probabilities are that this kind of solution is not applied often enough. In 1935, the stockholders of the Simms Petroleum Co. voted to dissolve the corporation. Under the laws of Delaware, the company's corporate existence is continued for 3 years from the filing of its purpose to liquidate. At the end of that time, if the liquidation has not been completed, trustees may be appointed to complete the operation. Numerous business enterprises, without economic justification for their existence, apparently keep going to avoid funeral expenses. Some pass through successive reconstruction processes before finally giving up the ghost. A certain railroad was, for a considerable period, a sort of presidential railroad: it had a failure every four years. But hope springs eternal and encourages the use of headache tablets when major operations are necessary. Efforts at reconstruction of corporations that should be dissolved merely postpone the fatal day.

3. Most often, some plan of reconstruction is worked out and offered to all parties concerned. The plan offered presumably is based upon the specific weaknesses of the corporation and attempts to overcome the difficulties that the corporation has encountered. If the trouble has been with the marketing of the products, new methods of distributing the corporation's goods are sought. If production methods are obsolete, changes are made at

this point. Only where necessary are changes made in the financial plan of the corporation.

**Reconstruction vs. Reorganization.**—Literally, reorganization means to organize a new corporation to take the place of the one that has failed. Sometimes this is necessary. If the affairs of the old corporation are in such bad shape that it has no good will to lose by dissolution, it may be well to let it disappear and be replaced by a reorganization. In such case, the name of the new company will be quite unlike the name of the old so that there may be no confusion. On the other hand, should the corporation possess good will that it does not wish to sacrifice, it will attempt to settle its difficulties without reorganization. If it cannot do so, the name of the new corporation will resemble that of the old as closely as possible. Dissolution of a corporation is fairly simple if its stockholders are willing to take securities of another corporation with which the first is affiliated. When the General Baking Corp. dissolved, its preferred stockholders were given one and one-half shares of common stock of the General Baking Co.—the operating unit—for each share held. In settlement for the dividends in arrears, they received \$3 in 10-year 5½ per cent sinking-fund gold debentures of the operating company for each share held. Many customers, in such cases, will never know that a change has taken place. Public utilities and railroads may lose franchises and other valuable rights if the corporation that owns them is dissolved. Under such circumstances, every effort is made to avoid reorganization.

Another factor that plays a large part in the use of reorganizations, in place of resorting to reconstruction, is the ability of the committees in charge to force settlements from creditors, in case reorganization is threatened or actually undertaken.

In contrast to reorganization, resulting in the dissolution of one corporation and the formation of another to succeed it, reconstruction is used to imply the remaking of any and all parts of the corporation. Refinancing, changing of products, production policies, marketing methods, etc., would all be classed under reconstruction, with or without being accompanied by reorganization. In other words, while reorganization undertakes to replace one corporation with another, reconstruction attempts to make repairs by whatever method seems most suitable.

**Single Creditor Reconstruction.**—Occasionally, reconstruction is simplified by having the obligations of the failing corporation owed to a single creditor. When the National Union Radio Corp. undertook to settle its obligations to the Radio Corp. of America, the latter canceled the notes, amounting to \$1,000,000, it held against the former, together with overdue interest; surrendered its block of 10,000 preferred shares, par \$5, and waived accrued dividends thereon; and canceled its option to buy 25,961 shares of common stock. In exchange, the R.C.A. received 250,000 shares of \$1 preferred stock of the National Union, convertible at any time into common

stock, share for share. To make sure its equities would not thereafter be diluted, the R.C.A. received a concession of 37 per cent of all future dividend disbursements upon both preferred and common stock.

**Degrees of Failure.**—As defined above, failure means inability to meet financial obligations when due. This definition suggests degrees of failure. Some corporations are merely financially indisposed; others are seriously ill; and still others are beyond hope of recovery. Some corporations that fail suffer from acute attacks which may pass with time, leaving the patient none the worse for the wear. Others enjoy chronic ill-health from which recovery or even permanent relief is impossible. Temporary insolvency results from inability to meet obligations at the time they fall due without confusing and upsetting the whole operating program of the corporation. Presumably its assets exceed its liabilities but are not in liquid form to meet them. Total insolvency implies an excess of liabilities over assets and suggests the necessity for dissolving the business in order to make all assets liquid. Only by this means can creditors hope to gain even partial satisfaction of their claims.

**Unrecorded Failures.**—In addition to the relatively few business failures recorded in the bankruptcy and equity courts, many voluntary readjustments are made with the consent of creditors and owners. Between those corporations which are crowned with the success that results in profits and the others which from time to time admit their inability to meet their obligations and hence are labeled failures, there exists, for a longer or shorter time, a horde of business enterprises that merit neither the crown of success nor the cross of failure as herein defined. They are not successes because they earn no profits. Yet they are not failures, as herein defined, because they meet their obligations.

For the most part, they are small business enterprises, either incorporated or existing as proprietorships and partnerships, all of whose capital is contributed by their owners. They continue to exist so long as their capital lasts. They may enjoy more or less indifferent success for a time but eventually, and perhaps gradually, they absorb their capital in meeting their obligations. Their disappearance is not heralded by any outcry because no one is financially embarrassed except their owners. Having used their capital in meeting current obligations, the managers of such enterprises quietly dissolve their businesses and drop out of the picture. The aggregate number of such experiences must be legion. Yet no tabulation is made of them, and no one records their passing. Their history is not recorded in the chapters that follow because the absence of creditors makes them unqualified for consideration as business failures.

In passing over the discussion of such experiences with only a brief reference to them, there is no intent to suggest that they are unimportant in the annals of American business. On the contrary, to those who bear the brunt of the losses, they are all-important. Such lack of success of business

enterprises means everything to those whose disappointments are recorded in the loss of their hard-earned savings. But since creditors lose nothing, there is presented no problem of rebuilding the business or even of arranging for the disposition of the assets. By definition, this has already been taken care of. Since this and the succeeding chapters deal with situations which demand that something be done about the business enterprises that have failed, we must omit further discussion of those whose managers and equity owners only are concerned with their lack of success.

**Causes of Failure.**—Corporate failures may be classified according to one of several plans. One common classification distinguishes between external and internal causes. This classification is difficult to apply because it undertakes to place personal blame upon management for internal causes of failure and more or less absolves it from blame for external causes. Perhaps it is true that failures occur because management has made mistakes. The question is: Were the mistakes due to neglect or were they unavoidable? On the other hand, is management always to be acquitted of blame for so-called external causes of failure? Suppose a war or a crop failure interferes with the plans of management and results in the failure of the corporation. Has management no responsibility for attempting to forecast such occurrences and to discount their consequences? Few causes of failure carry no suggestion of managerial weakness. Most of them have external complications.

**Causes vs. Symptoms.**—Records of failures sometimes list as causes what should more properly be tabulated as symptoms. For instance, lack of circulating capital is a prolific cause of failure, according to financial chronicles. This is a conceivable cause of failure in a very tight money market, when the common sense of managers of financial institutions is on vacation. Under such circumstances, all rules of business procedure are suspended except the one adopted for such emergencies which may be stated briefly as follows: "Don't lend any amount to anybody for any purpose." At other times, a corporation with good credit can secure needed circulating capital without much difficulty.

**Competition.**—Failures are frequently charged to competition. The relationship is very interesting. Ineffective gestures at competition can be ignored. Strong competition—if not too strong—acts as a spur to accomplishment and efficiency in operation. Too strong competition may not be competition at all. It may be evidence of the inability of the weak enterprise really to compete with the strong. Jones may find solace in the statement that he failed because of the competition offered by Brown. One must wonder what qualities Brown possessed that Jones lacked. If a pugilist and a philosopher should compete, what game would they play?

In a similar manner, we learn that manufacturers of bicycles failed because of the competition of automobiles. Bicycles never really competed



with automobiles. The development of the latter made the common use of the former obsolete.

When all the consumer's dollar is needed for the purchase of necessities, purveyors of luxuries may be forced out of business. Commodity competition may be a cause of failure under such circumstances.

Competition is more often an alibi for failure than its cause. If all producers or distributors in a given market are forced to suffer losses because of too great competition, we could perhaps assign competition as a cause of failure. Even under such circumstances, competition is more apt to result in combination than in failure.

**Changes in Demand.**—Another way of expressing the idea of commodity competition is to speak of changes in consumer demand for a given product. Not all manufacturers of buggies and carriages failed when automobiles became popular. Some converted their factories into automobile plants and enjoyed success in the production and sale of the product that met the consumer's fancy. Others who insisted upon continuing to produce what almost nobody wanted any longer dug their own graves and joined the hosts of forgotten souls.

Some corporations, apparently at the height of their success in the development of a given product, mature plans for producing a different line of products—in anticipation of a change in consumer demand. Indeed, the change may be induced by the corporation equipped to serve the demand for a new product. The good old football rule for using a good offense as a means of defense may work in business as well. Vested interests are hard to dislodge. Greater success may be attained by ignoring them in the pursuit of new fancies. Corporations that are not fortified against changes in demand, whether resulting from boredom of consumers or from aggressiveness of competitors, may expect to fail as soon as such changes occur.

Recent railroad failures have been due, in part at least, to the shift to the use of other types of transportation agencies. With the relief of the pressure of these other kinds of transportation during the Second World War because of tire and gasoline shortages, railroads soon recovered so much of their lost traffic that their facilities were taxed to the limit to render the service demanded of them. Priorities had to be established to make sure that the most urgent needs would receive first attention. This kind of a recovery represents a shift in demand that is made possible only when more desirable means of satisfying human wants are no longer available. It is seldom that an industry which once loses public favor is given an opportunity to recover custom that it has lost.

Incidentally, one of the curious inconsistencies in the development of American business is the fact that corporations frequently build their plants and make their plans for eternity when all about them is evidence of the

permanence in their own fields of operation work very hard and persistently to undermine public favor for other commodities and service. In a very real sense, every producer is making a bid for the consumer's dollar. If the consumer responds favorably to the allure of automobile advertising, his demand for beefsteaks may decline. And if some new product makes a stronger appeal than either of these, he may not only cut down on his consumption of beefsteak, but he may drive the old car another year or two longer than he had expected in order to pay for the new gadget. In fact, the path of progress is strewn with the wrecks of enterprises and even of whole industries whose products have been superseded in public favor. Seldom do catastrophic changes take place overnight. They usually give notice of their coming in some form or other. The business leaders who read and heed these notices fortify themselves in some manner against their consequences. Others fail.

**Substitutions.**—Pious denunciation of the fickle public demand seldom restores lost customers. The business whose products or services no longer appeal has two alternatives—to quit business or to change its products. Some should undoubtedly quit. Few seldom do until the sheriff locks their doors. But since the buying public is king, the least that the manager of the failing business should do is to try to find out what changes he must make to recover his lost trade. If he is selling a service, he needs to cater to the wishes of the buying public. It took the railroads a long time to offer faster trains and more comfortable travel to passengers who had responded to the appeal of the airplane and the automotive vehicles. Substitution of a new line of products may be the only practicable answer for a corporation whose former output is no longer demanded. It may not be easy to shift over from one line of products to another. That is why some experiments may be necessary on a tentative scale while the corporation is still engaged in the production of the old product on a reduced scale of operations. Some corporations, for example, are giving much attention to the field of plastics, even though it may seem far removed from their line of business. Others seem to find no interest in changes of any kind.

**Overexpansion.**—Still another way of expressing the idea of the effects of competition upon failures is to say that the failures are due to overexpansion—to the attempt to absorb more of the market than can be reasonably hoped for. Overexpansion *per se* seldom causes failure. Methods commonly used to effect overexpansion, especially the use of other people's money, frequently result disastrously. The evils of overexpansion are too numerous for discussion here. Chief among them is the evident incompetence of management. The fact of overexpansion affords sufficient evidence for conviction. Added to this is the common experience that a management able to make a profit on a small scale of business operations may be bewildered by the complications of larger responsibility. This is a probable

result of expansion that is too rapid. Being the child of optimism, overexpansion frequently finds waste and inefficiency its chief playmates. As a consequence, increased gross revenue may not result in increased net income. Should it result in negative net income, failure may follow.

Overexpansion is a particularly prolific cause of failure during periods of economic prosperity. Bigness appears to be one of the obsessions that afflict most business leaders. Few of them seem to be content to do a good job on a small scale. The rapid growth of our country has invited business operations on a grand scale. Whenever conditions favor expansion programs, there are always plenty of business executives ready to take advantage of them. Every period of prosperity is aggravated by tremendous expansion operations. And every subsequent period of depression is made deeper and broader because of the consequences of unwise expansions for which there is insufficient continuing demand.

**Business Cycle.**—Whenever overexpansion becomes the fashion, we blame the business cycle for its results. It almost seems as if the arbiter of business fortunes shaped the business cycle to coincide in length with man's memory. Or is the latter the limiting factor in determining the former? Anyhow, the recurrent periods of the cycle never seem to teach us much about the probability of their recurrence in the future. Whenever we are able to shake off the shackles of depression and launch a new campaign of business expansion, we become so intent upon the task in hand that we forget the lessons of the past. The dawn of the New Era always finds more people up at sunrise than at any other time. Only old fogies sleep late on such occasions. They are the only ones whose consciences will let them sleep on the "morning after" the New Era. Since most business enterprises feel the pinch of the business cycle, it is probably proper to class it as a major cause of failures. If and when business leaders can be made to believe this, the cycle will be well under control. Although there is no common agreement about the causes of the cycle, it is, in part at least, the result of ambition, optimism, and impatience to forge ahead. If overexpansion can be made a curse and every business leader can be induced to avoid it as such, perhaps we can all be blessed and enjoy the fruits thereof.

**Fortuitous Causes.**—Crop failures, fires, and windstorms may cause corporate failures. Undoubtedly there are many unpredictable, external causes of business misfortunes. However, the risk of loss from most of them can be minimized by insurance so that failure need not result from their occurrence. Caution should be used in classifying causes of failure under the general title of acts of God. The devil and his human accomplices should be given their due also.

**Financial Carelessness.**—Failures are frequently the result of unwise financial policies arising out of corporate successes. The profits promised by trading on the equity invite unwise use of funded debt which may prove

disastrous. Cash balances in the face of glowing future prospects are dissipated or reduced below safe levels by dividend declarations and unwise expenditures for other purposes. Accounting practices, resulting in absorption of surpluses without proper provision for reserves, may embarrass future operations of the corporation. Payment of excessive dividends and interest charges may weaken the financial stability of the corporation and make it unable to weather future storms.

Seldom would corporate directors pursue financial policies that would lead directly to corporate failures. Imbued with the optimism of prosperity, they sometimes initiate policies that cannot be sustained in times of adversity. If and when the latter come, the corporation may be unable to stand the strain intended for other and more favorable conditions.

The specific evidences of financial carelessness can be found under various sets of circumstances. The corporation that trades on the equity and spreads its proprietorship capital over too many layers of interest-bearing obligations may find itself financially embarrassed when earnings drop below its fixed charges. Since it has obligated itself to pay interest whether earned or not, the absence of net earnings will not relieve it of the necessity for either paying interest and rents or admitting its failure to do so. Even where fixed charges do not assume such important positions in the financial affairs of a corporation, financial carelessness may be evident in too liberal distribution of earnings during prosperous times. While this practice may not be a common fault of corporations generally, it is certainly a prolific cause of failure for some corporations that use it.

**Governmental Acts.**—A variety of laws, court decisions, and administrative orders may result in the failure of specific business enterprises. While in but a few instances would a governmental agency deliberately set out to cause a business failure, the consequences may be just as bad as if intent were present. Intent is present of course in those cases where a business is being operated in violation of a law. Some laws and some court decisions have as their avowed purpose the break-up of business practices, without which the enterprise cannot continue. Some indictments under the Sherman Act and laws intended to drive out certain business practices are of this character.

For the most part, however, the effects of governmental acts that become causes of business failure are indirect in their operation. Here the number is legion. Industries that owe their existence to high protective tariff barriers against foreign competition may fail if the tariff rates should be lowered to permit the entry of cheaper foreign products. Conversely, industries that depend largely upon foreign purchases for their success may fail if a high-tariff policy discourages foreign purchases because the purchasers cannot sell their goods in this country. Many of the laws passed during the decade of the 1930's affected adversely the business policies of many industries. Placing of ceilings on hours of labor and floors under wages results in driving

out certain types of business operations. All such legislation reflects the social philosophies of those who are responsible for its passage. The consequences are thought to be sufficiently desirable to risk even the complete elimination of such jobs as cannot be continued because of the legislation.

There is still another type of governmental action that may cause widespread business failures. In a time of great national emergency, such as characterized the Second World War, the needs of the armed forces may require so much of the materials that can be produced in certain lines of industry that little or nothing is left for private use. As a consequence, such industries as depend upon such materials may be forced to close their doors. If some enterprises are not well enough fortified to stand a shut-down for some months or years, they may fail. Even the drafting of some key individuals to serve in the armed forces may result in the failure of the business enterprises which they managed.

These are but a few of the ways in which governmental action may result in business failures. This list of illustrations could be extended if an attempt were made to catalogue all such actions. To mention but one or two more, taxation may fall so unevenly upon business enterprises that some may fail to survive. Indeed, some tax laws have been enacted for the purpose of hampering certain types of business operations. This is true of taxes on chain stores and the multiplication of taxes on the earnings passed along through several layers of holding companies. Even the granting of a patent may spell the doom of a competitor, while the withdrawal of monopoly privileges at the expiration of a patent's life may invite competition of a kind that cannot ensure the continued success of the original owner of the patent protected business.

It was stated above that seldom would a governmental agency deliberately set out to ruin a business enterprise. Nevertheless, it must not be assumed that the government is made up only of men of integrity, with thorough training and competence to perform the tasks assigned to them. Too frequently the "governors" are recruited from the ranks of those who have failed to succeed at other lines of endeavor. It is not surprising, therefore, that their blundering and their mistakes result in hardship for business enterprises, the consequences of which may even be failure. The growing tendency toward the creation and development of administrative law, which lacks the sanction of both the public discussion characteristic of legislative enactment and the judicial review of court decisions, may mean greater dangers to business operations. Administrators who fail to understand business operations and who have little sympathy for their objectives may be the cause of many future business failures that should be avoided.

**Managerial Weaknesses.**—Managerial weaknesses are so numerous and so varied in kind that their classification is exceedingly difficult. Only the outstanding weaknesses are mentioned here:

1. Some corporate failures evidence success, *i.e.*, success on the part of crooked managers who have followed nefarious practices in milking the assets of the corporation and in looting its treasury. Piracy is still common, and corporate buccaneers are all too numerous for the good of the stockholders and others whom they are supposed to serve. Manipulation of accounts is a common weapon used by such managers with fraudulent intent.

2. Inexperience is a common weakness of corporate managers. Experience is a relative term. A director might serve admirably on one board and be useless on another. The scope of operations and the measure of responsibility sometimes make otherwise experienced individuals as helpless as neophytes at the business. New conditions may call for qualities never demanded by and hence never developed from past experience. Fair-weather managers may be poor pilots in storms.

3. Extravagance, neglect, and speculative tendencies on the part of managers frequently jeopardize the fortunes of the corporations directed or misdirected by them. Directors are human and exhibit human traits. With profits large and with operations at capacity, neglect is almost sure to follow. Extravagance and waste creep in when plentiful profits depreciate the value of each profit dollar. Deceived perhaps by the large profits that flow from large orders on a rising market, directors may think they alone are responsible for the good fortunes that have befallen their corporation. What is more natural than that they should show a willingness to make the corporation even more fortunate by giving it the further benefit of their wisdom in making speculative commitments for it? When the roll is called later, failure answers for extravagance, waste, and speculative tendencies.

4. Incompetence is a sort of omnibus word, potent in action, yet hard to define. Every internal cause of business failure is in some manner related to incompetence of management. Outworn methods of production, unwise depletion of cash in dividend declarations, overexpansion—all are evidences of incompetence of management. Even so-called external causes of failure, such as fires, windstorms, and crop failures, are not wholly unrelated to incompetence of management. Most so-called external causes can be insured against or can be anticipated in time to prevent their full effects upon the fortunes of a business enterprise. In fact, incompetence is a sort of blanket indictment from which management can seldom escape in case of failure.

In short, any effort to assess the blame for business failures must start with an analysis of managerial weaknesses. In many instances there will be no need to look further. It will bear repeating at this point that, except for the increasing part played by governmental agencies, management is the one most active factor in industrial organization. Capital is distinctly passive. As has been pointed out in various parts of this text, the owners of capital are neither organized nor articulate. They turn their capital over to the

managers of corporations and hope for the best. Other than this, they add little to and subtract little from the responsibility and the authority of management. Likewise, labor is essentially a passive contributor to business operations. While labor organizations are growing in strength, their leaders and their members are primarily concerned with questions of wages, hours, and working conditions. Production, distribution, expansion, financing, and other policies are determined by management. Since the authority for making decisions and determining policies rests with management, the responsibility for the results must be placed there also. This means that a twofold relationship is present and must be accepted by all concerned. Management must be credited with most of the industrial progress we have enjoyed to date; but it must also be charged with most of the failures we have experienced.

**Failure Records.**—During the past half century or so—during which time any serious attempt has been made to keep records of business failures—such failures have been related in part to business cycles and in part are independent thereof. According to Bradstreet's survey of business failures and Dun's record of insolvency, the percentages of all businesses that fail seldom drop below three-quarters of 1 per cent and seldom rise above  $1\frac{1}{2}$  per cent. This indicates that even in the most prosperous years the record of business failures is relatively high. These percentages are undoubtedly considerably lower than actual tabulations of all failures would produce. Only failures of such magnitude as to attract public attention are recorded by Dun and Bradstreet. Many small failures are not recorded. Also information about many adjustments and compromises with creditors never become public property.

**Cumulative Effect of Failures.**—As pointed out in another chapter, business relationships are like a set of dominoes stood on end in a row. The fall of one will cause the whole row to topple over. The failure of one business enterprise frequently produces failures of various others. If *A* cannot meet his obligations to *B*, *B* will be unable to pay *C*. The increase in the number of industrial combinations has an effect upon intercorporate causes of failure; for the failure of one company in a system may bring disaster to its associates.

**Consequences of Failures.**—The majority of new business enterprises fail, most of them within a year after they start. Others fail from time to time. This represents a tremendous waste of the resources of those who engage in business and of those who become financially involved. Such failures, particularly when they become numerous, have consequences that carry more than economic connotations. A business failure establishes in the minds of all who are acquainted with it a feeling of instability and insecurity. This may provide the reason for a favorable reception for social and economic philosophies that question the fairness of free enterprise and private prop-

erty. Instead of analyzing the capacity of the former leader of a failed business to conduct its affairs successfully, both he and his friends are likely to think that some mysterious forces beyond his control have stacked the cards against him.

None would deny that the possession of resources is an invaluable aid to the creation of successful business ventures. Conversely, the man without access to resources is not likely to become a successful manager of a business that he can call his own, regardless of his ingenuity and initiative. To the extent that American business is concentrated in large units, thereby restricting the opportunities for ambitious individuals to rise to leadership, increasing questions will be raised about the desirability of continuing the present economic order. Because society has such a heavy stake in the consequences of business failures, perhaps we should undertake to find means of avoiding the large number that occur. This would not be an easy task. In a democracy like ours, we believe in a large measure of freedom of individual judgment, including the freedom to make mistakes.

### QUESTIONS AND SUGGESTIONS

1. What is the meaning of business failure? What are the steps in business failure?
2. What kinds of control may follow the admission of failure?
3. Why is mutual confidence desirable when business enterprises fail?
4. What types of settlement follow failures?
5. What degrees of failure may business enterprises suffer? Differentiate between reorganization and reconstruction.
6. What are unrecorded failures? Are they really failures as defined in this chapter?
7. Distinguish between causes of failure and symptoms. What are the common causes of failures?
8. Distinguish between external and internal causes. Is competition a frequent cause of failure? Explain.
9. When a product or a service is no longer demanded by the public, what alternatives are open to the corporations that supply it?
10. In what way may overexpansion become a cause of failure?
11. What can be done about the business cycle as a cause of failure?
12. What are fortuitous causes of failure? Give examples. Give examples of financial carelessness that may lead to failure.
13. What governmental acts may result in business failure? Are any of these ever planned to produce failure? Explain.
14. How may taxation produce business failure? How may the granting of a patent result in business failures?
15. What managerial weaknesses result in failure? What do you understand by incompetence? Why is management chiefly responsible for most business failures?
16. What is meant by the cumulative effect of failures?
17. What kinds of consequences result from business failures?

### SUPPLEMENTARY READINGS

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- LINCOLN, E. E.: "Applied Business Finance" (New York: McGraw-Hill Book Company, Inc., 1941), Chap. XXIV.
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### SUBJECTS FOR INVESTIGATION

1. From the corporate news section of the *Commercial and Financial Chronicle* or from other sources, find evidence of failure of two corporations. Using previous issues of the *Chronicle* and other sources, see if you can find the causes of these failures and the approximate date the actual failures occurred.
2. Find a corporation that you think is merely financially indisposed. One that is seriously ill. One that is beyond hope of recovery, without drastic changes in its policies. Justify your answer in each case.
3. From your observation or from conversation with others, describe an unrecorded failure.

## CHAPTER XLII

### RECONSTRUCTION PROCEDURE

**Simple Forms of Control.**—In the preceding chapter, brief mention was made of the control of a failed business by the existing management or by a creditors' committee during the moratorium period when interested parties try to find a formula for the final settlement of the financial problems of the business. Either of these methods of temporary control has the advantage of simplicity. Where mutual confidence prevails, either may operate to the satisfaction of all concerned. If and when this mutual confidence is shaken, these simple forms of control become unstable and may be replaced by one of the plans discussed below. In fact, most failures of consequence sooner or later find their way into court.

#### EQUITY RECEIVERSHIP

**Appointment.**—The older of the two plans that form the subject matter of this chapter is the equity receivership. Until recently, as soon as a corporation admitted failure, it was customary for a creditor to take his claim to a court of equity and ask either for judgment against the debtor or for the appointment of a receiver. In either case, the result may be the assumption of control over the business by the court. In some cases it is the debtor who takes the initiative in asking a friendly creditor to bring suit. The indictment may be drawn by the attorney for the debtor. As a result, a receiver may be appointed before most of the creditors know about it. This is called a "friendly receivership" in contrast to the kind that results from a suit by an unfriendly creditor. The common use of receiverships has resulted in standardizing the rules under which they operate.

In selecting a receiver, the court is free to appoint whomever he sees fit. Creditors, managers, and other interested parties may make suggestions, but the court is not bound to follow any of them. In case of receiverships for public utilities, even municipal authorities try to influence the choice of the court. Sometimes coreceiverships are applied for in the hope that more than one interest will be represented. The head of the failed business, one of its directors, a creditor, a banker, or a disinterested party may receive the appointment as receiver. The common appointment of attorneys is readily understood since they are the men with whom the court may be best acquainted. In case coreceivers are appointed, one may be an official of the failed business and the other an attorney.

**Duties and Responsibilities.**—As soon as the receiver is appointed and qualified, he assumes control over the affairs of the failed business. The board of directors is shorn of all authority for the period of the receivership. Officers usually tender their resignations to the receiver. He is free to make such changes in personnel as have the sanction of the court. He may need the advice and assistance of key men and therefore will make few changes even at the top. The receiver is responsible only to the court that appoints him. Stockholders as well as directors are rendered powerless during the receivership. Creditors and others must postpone action against the corporation, except with the approval of the court. By this means, dissipation of the assets is prevented. The powers of the court, exercised through the receiver, are very broad. It may mark time, pending a settlement of the difficulties of the business enterprise by creditors and stockholders; or it may institute aggressive action to rehabilitate the business without waiting for a settlement to be proposed by others. It can attempt to operate the business on a self-sustaining basis, or it may issue receivers' certificates for the purpose of obtaining the means of meeting operating expenses and capital improvements. Where certificates are issued, they are occasionally sold for cash. More often they are given in payment for materials and supplies that the business requires. They are given such priorities as the court may sanction. The bargaining power of those who accept them helps to determine this question.

**Advantages of Receivership.**—Equity receiverships possess certain advantages in comparison with creditors' committees or consent operation, the most important of which are the following:

1. The receivership may fix relationships as of the day on which the appointment of the receiver is authorized. Any simpler form of control leaves doubt of the nature of claims and priorities thereof because of legal action that may be taken by the claimants.

2. The receiver can force claimants to establish their claims and can refuse to consider any that are not so validated. A creditors' committee may be seriously embarrassed by invalid claims which it cannot ignore without threat of suit.

3. Recalcitrant creditors may be effectively squelched by a receiver. After the receiver takes control, no creditor is permitted to press his claim. The debtor can enjoy a breathing spell, free from harassing creditors who would like to threaten dire action unless their claims are met immediately. Creditors' committees are limited to the use of their powers of salesmanship in dealing with those who do not wish to play the game. Receivers may ignore the threats of dissatisfied creditors.

4. Not only in dealing with creditors but with others as well, the receiver possesses decided advantages. Through the court, the receiver is in position to repudiate or to force modifications in contracts that are burdensome to

the debtor. Burdensome long-term leases and other uneconomic contracts are frequently modified or repudiated by receivers.

**Receiver and Final Settlement.**—By way of contrast with the trusteeship, discussed below, it is significant to point out that neither the receiver nor the court that appoints him is primarily concerned with the final settlement of the affairs of the failed business. As indicated above, the receiver manages the business, pending a settlement by others. If and when other interested parties arrive at a settlement, the court is concerned with these questions: (1) Have all expenses of the receivership been met? (2) Has provision been made for taking care of receivers' certificates in a manner that meets the approval of the holders thereof? (3) Are all parties at interest in agreement on the plan of settlement? If the answers to these questions are in the affirmative, the equity court is not likely to undertake to pass judgment upon the fairness or the feasibility of the plan of settlement. It is only when satisfactory answers to these questions are not forthcoming that the court may refuse to vacate the receivership. If there are parties at interest who refuse to go along with the proposed plan, a foreclosure sale may be the final outcome of the receivership.

#### PROTECTIVE COMMITTEES

**Appointment.**—As soon as a business enterprise admits its failure to meet its obligations and some plan is formulated for controlling its affairs pending their final settlement, self-appointed committees purporting to represent the various parties at interest are formed. They are called "protective committees." It is customary for such a committee to be formed first, with its clients to be found later. For example, a banker may organize a committee to represent the first mortgage bondholders. This committee will then request all holders of this class of bonds to agree to have this committee represent them. The success of their request will depend upon the faith that the bondholders have in the committee members. Well and favorably known banking institutions will attract a greater following than individuals. Not only security holders but all other classes of claimants against the failed business may be represented by protective committees.

Not every bond- or stockholder, regardless of the amount of his holdings, is competent to serve on a protective committee. Its members should possess the ability to discriminate between the essential and the nonessential, to give all questions due weight, to grasp the meaning of financial reports since balance sheets and income statements play such a large part in determining the questions at issue, and to recognize the proper times and occasions for "standing pat" and for compromising. It seems commonplace to say that those selected should be men of integrity who will faithfully represent the people they are supposed to represent. The experience with protective com-

mittees unfortunately does not always measure up to this commonplace statement.

**Deposit Agreements.**—After organization, each protective committee formulates a deposit agreement, to which depositors subscribe automatically by the deposit of their securities or other claims against the business. Such agreements are carefully drawn, in order to give the committee power to meet every emergency that might arise in the progress of their efforts to protect the interests that they serve. Common provisions of such agreements include the following:

1. Committees have power to add to their numbers, to accept resignations, and to fill vacancies.

2. They are authorized to employ whatever expert services they deem necessary, including those of accountants, attorneys, and engineers; to arrange for their compensation and expenses; and, if necessary, to pledge deposited securities as collateral to ensure payment of all obligations.

3. In some cases, members of the committee agree to serve without compensation other than expenses. In other cases they receive compensation determined by themselves, to be paid from the same sources as above.

4. Committees are usually empowered to adopt a plan of reconstruction or to approve one formulated by others. Provision for review of such plans by depositors is usually made, together with opportunity for them to withdraw from the agreement if the proposed plan is unsatisfactory. In case of withdrawal, they are required to pay their prorata share of expenses.

**Position of Investors.**—For the most part, the state of mind of an average investor asked to deposit his securities with a protective committee is bewildered. He is facing a new experience—one that he did not visualize when he purchased his securities. He can be a good “yes man” and cooperate with his committee, or he can do nothing. These are almost the only alternatives open to him. Occasionally, independent committees are organized by aggressive leaders to oppose a program of reconstruction offered by bankers or management. Even where this situation obtains, the average security holder has no ready means of selecting the committee that merits his support. Expediency, the urge to do something, the corporation’s need for cash, and other considerations bring pressure upon the security holder to play the game by signing up with his protective committee.

**Functions of Protective Committees.**—In the first instance, the function of the protective committee is fact finding. It must try to determine what position its group occupies in relation to asset values and prospective earning capacity. In the absence of definite information, one group with stronger claims may be taken advantage of by another group not so well entrenched. Each committee must fortify itself as best it can for the struggles usually encountered before a reconstruction plan is finally approved. The information needed should include the following:

1. The books of the corporation must be carefully audited to determine the exact status of its affairs.
2. Contracts and other legal questions of various kinds must be reviewed by competent attorneys to determine what to do with them.
3. Estimates must be made of the chances for success of the corporation in case it is reconstructed. This may involve a market analysis of its products and services and other related subjects.
4. Estimates must be made of probable success in disposing of new securities in the open market, to holders of existing securities, or to bankers.
5. The committee must take an active part in the formulation of new financial plans and otherwise in working toward a final settlement that will best serve the needs of those represented by the committee.
6. Occasionally protective committees act for their clients in buying the assets of the business at foreclosure sale.

**Weaknesses of Deposit Agreements.**—As pointed out above, protective committees are self-appointed. They see to it that deposit agreements give full protection to committee members. However carefully drawn, such agreements cannot make honest men out of committee members who see fit to take advantage of their position to serve their own selfish purposes. Incompetence, dishonesty, bad faith, and excessive charges complicate the problems of the committee. Whenever self-seeking men dominate such committees, the uninformed and unorganized security holders become easy victims.

Because these committees are self-appointed and self-regulating, there is nothing to prevent representatives of management from selecting members of a protective committee for bondholders. As a consequence, any investigation of the acts of management will produce whitewashing results. In the formulation of a reconstruction program, it is easy for such a committee to make recommendations that will adversely affect the interest of its clients.

**Reconstruction Committee.**—Since each party at interest will be represented by a separate committee, it is to be expected that their programs and recommendations will be in violent conflict with each other. If there were five committees in any specific case, one would expect five different and conflicting plans. As a consequence, a joint committee, representing all protective committees, must be organized to work out compromises. This joint committee frequently finds it necessary to formulate a plan of its own, hoping to obtain sufficient concessions from its various members to ensure the common acceptance of its plan. The extent of the concessions may be governed by bargaining ability rather than by the strict rule of priorities of claims.

Once a plan is agreed upon by the reconstruction committee, it is referred back to the various protective committees. These in turn refer it—usually with a recommendation for approval—to their clients and to other claimants

of the same class. Those who do not actively dissent and withdraw from the agreement are assumed to approve the plan. With the approval of all concerned, the new plan can usually be made effective without much difficulty. Without such approval, complications arise that may be resolved only by a judicial sale of the assets.

**Dissenters.**—Dissension has been common under the procedure of settling the affairs of a failed business through the use of protective committees. It appears in various forms. There may be a fight for control of depositors. Two committees, each self-appointed, may contend for the deposit of the same class of securities. Influential security holders may have their own ideas of settlement which do not conform to those of any committee. In either event, compromise and final agreement is necessary to effect a settlement.

Individual security holders may refuse to take any part in the settlement proceedings. Three separate groups may be classified in this category:

1. Some play only a passive part. Lack of experience and absence of acceptable advice make them uncertain about their duties and opportunities. Consequently, they do nothing. They do not deposit their securities; neither do they approve new plans that may be worked out.

2. Some are conscientious objectors. They seriously and sincerely object to the methods used to rebuild the failed business.

3. A third group may properly be classed as "hijackers" since their purpose is to make personal gain at the expense of the other claimants. They operate within the law by acquiring title to more or less worthless claims and then insist upon full legal satisfaction as the price of withdrawing threats to bring foreclosure suit.

The first of these groups seldom causes lasting trouble. Eventually its members will accept the consequences of plans worked out and agreed to by others. If the members of the second group are reasonable in their demands, they can usually be convinced of their errors. Or, if they are right, plans can be modified to suit their just demands. If neither can be accomplished and the minority interest is small in amount, it can be bought out by majority interests. Even in the case of the hijacker, it may be cheaper to buy him out than to resort to foreclosure sale. At least that is his hope.

**Legal Remedies.**—Laws and courts recognize the probability of conflicts of interests in the case of business failure and try to deal fairly with all interests. Statutes prescribe an appraisal of assets as the basis for settling with minorities. Such terms as "value," "fair value," and "full market value" are used with a connotation of greater exactness than actually works out in practice. If the objecting minorities are large or unreasonable in their demands, the laws provide the foreclosure sale as the final method of determining disputes. At such a sale, presumably the property is sold to the

highest bidder and the proceeds are applied to the satisfaction of claims against the business in the order of their priority. In practice, such property is sold to the reconstruction committee. Dissenters may be frozen out of at least a part of their claims. Those who have agreed to a reconstruction plan can use their claims as a substitute for cash in bidding for the property. As a consequence, they may be the only bidders. To prevent them from taking advantage of minorities, the court sets a minimum or "upset" price. Failure to receive a bid of at least this amount will cause the court to refuse to confirm the sale. It may be necessary, in case of no bids, to lower the upset price at a subsequent offer of sale. In the absence of objection, the court may arrange a private sale to avoid the unfavorable publicity and expense of a public sale.

## CHAPTER X

**Background of the Chandler Act.**—In 1933, Congress passed the far-reaching amendment of the Bankruptcy Act known as Section 77 and described in Chap. XXXVII of this text. In the succeeding year, its principles were extended to the reorganization of nonrailroad companies in the form of Section 77 B. During the succeeding four years, the Securities and Exchange Commission gave careful study to the operation of these changes and to the financial principles involved. The result of this study, supplemented by the activities of others interested in the same subject, resulted in sweeping changes in the Bankruptcy Act in 1938 under the popular name of the Chandler Act. Chapter X of this act represents an elaboration of Section 77 B. It seems likely that Chapter X will be resorted to in many cases where otherwise the equity receivership would be used. In fact, where assets of a failed business enterprise are in the hands of an equity receiver, they may be taken over in the manner described below for reorganization under the Chandler Act.

In passing this law, Congress did more than provide a substitute for the equity receivership. A receivership proceeding looks primarily for a means of controlling a business enterprise in financial difficulties while its various claimants are seeking satisfaction. In the Chandler Act the emphasis is placed upon the rehabilitation of the debtor—not the satisfaction of the creditors. Creditors—as will be shown below—have their rights considerably curtailed under the new procedure.

**Filing of Petition.**—A petition for the application of Chapter X may be filed by the board of directors (or an executive committee) of a corporation in financial difficulties, by a trustee under a bond indenture, or by three or more creditors having aggregate claims of \$5,000 or over. A voluntary petition must "allege insolvency or inability to meet debts as they mature; the nature of the debtor's business, its financial condition and capital structure . . . its desire that a plan of reorganization be effected." An involun-



tary petition (filed by creditors) must show, in addition, that an act of bankruptcy has been committed by the debtor.

Any interested party may file an answer to a petition under Chapter X. Herein is one of the outstanding features of this law. Throughout its administration, it is characterized by an attempt at all times to give interested parties opportunities to be heard. If the judge determines that the petition complies with the provisions of the law and is filed in good faith, he must approve it.

**Administration.**—Since time is of the essence in solving the problems of business enterprises in financial difficulties, it is important that all who are working toward that end should work together. Under equity receivership, there is no single-headed control. The court has control over the assets while interested parties are trying to work out a new plan. The receiver frequently likes his job and is not anxious to give it up. Receiverships running for several years are not uncommon, while some running for several decades are not unknown. Under the Chandler Act, both assets and procedures for working out new plans are under the same jurisdiction. The court administers the entire program through duly appointed officers.

If the indebtedness is less than \$250,000, the court may continue the debtor in possession, acting, however, for the court and under its orders. In such case the court may appoint a disinterested examiner to investigate the debtor's affairs and, if requested by the court, to file plans for rebuilding the business. If the indebtedness exceeds \$250,000, a disinterested trustee or trustees must be appointed. In addition the court may appoint a director, officer, or employees of the debtor as a cotrustee. Consistent with the policy enunciated above, interested parties may object, at the time of appointment or at any subsequent time, to the continuance of the debtor in possession or to the appointment of a specific trustee. The court is bound to give attention to such objections.

**Functions of Trustees.**—At the outset, the trustee takes possession of the estate of the debtor and operates it under directions from the court. In other words, he performs this function much as the equity receiver does. With the approval of the court, the trustee may issue certificates for cash, property, or other consideration for the purpose of carrying out his duties. The procedure parallels the issuance of receivers' certificates by an equity receiver. But this is only the beginning of the trustee's functions. If the court directs, he shall "investigate the acts, conduct, property, liabilities, and financial condition of the debtor, the operation of its business and the desirability of the continuance thereof." The report of the trustee to the court on these subjects is made available "in such form and manner as the judge may direct, to the creditors, stockholders, indenture trustees, the Securities and Exchange Commission, and such other persons as the judge may designate."

The trustee is expected to formulate a plan for the settlement of the financial problems of the debtor. Meantime creditors and stockholders and their representatives are invited to submit suggestions or proposals for such a plan. Upon receipt of such suggestions, the trustee is expected to try to reconcile differences among the interested parties. If he finds that he cannot do so, he reports his reasons to the court and a hearing is set to try to obtain concessions from conflicting interests. While this search for a plan of final settlement proceeds, the trustee must report to the court—as often as requested—on the current operations of the business. These reports are all made available to all interested parties.

If the trustee formulates a plan, he submits it to the court which sets a time for a hearing on such plan and on any objections, amendments, or substitute plans that may be proposed by the debtor or by any creditor or stockholder. The court may permit a labor union or employees' association, representing the employees of the debtor, to be heard on the economic soundness of the plan as it affects their interests.

**Participation by Securities and Exchange Commission.**—After the hearing mentioned in the preceding paragraph, but before the adoption of any plan, the judge may, if the indebtedness does not exceed \$3,000,000 and shall if it does, submit the plan to the Securities and Exchange Commission for examination and report. This report is advisory only. The court may not approve a plan until it has given the commission a reasonable time to study the same and file a report, unless the commission gives notice that it will not file a report. In addition, the commission may, upon its own motion, intervene in an advisory capacity in any proceeding under Chapter X. It may not appeal or file a petition for an appeal in any such proceeding; but it may participate in appeals filed by others. During the year ended June 30, 1945, the commission participated in the reorganization of 141 companies (116 principal debtor corporations and 25 subsidiaries) with total book assets of \$2,039,439,000 and indebtedness of \$1,369,751,000.

**Approval of Plan.**—After the hearing and after an opportunity has been given to the commission for comment, the court shall enter an order approving the plan if he finds that it complies with the law and that it is "fair and equitable and feasible." At this point particularly, the reader will recognize a definite break with the responsibility of the court under equity receivership where private parties alone determine the character of the plan. After the court approves a plan, the trustee must submit the following to all creditors and stockholders who are affected by the plan: (1) the plan and a summary thereof; (2) the opinion of the court and a summary thereof; (3) the report, if any, filed by the commission; and (4) such other matters as the court may deem necessary or desirable for the information of creditors and stockholders.

With the written consent of the holders of two-thirds in amount of each class of allowed claims (exclusive of claims not affected by the plan) and of

a majority of each class of outstanding stock affected by the plan, the plan may become effective. If the debtor is determined to be insolvent, the consent of the stockholders is not necessary to make the plan effective. If the above votes for the plan are cast by the respective classes of claimants, the corresponding minorities are bound by the plan. In effect this changes our concept of the sanctity of contracts by permitting majorities to determine issues for minorities. It rules out all actions by minorities of whatever kind, once the plan is approved as above stated.

**Dissenters.**—The only dissenters that Chapter X recognizes are those who possess enough claims to defeat the two-thirds and majority votes described above. If less than two-thirds in amount of any class of creditor claims fail to approve the plan, provision must be made to pay them the realization value of their fair and equitable share of the assets of the debtor. In like manner, similar provision must be made for stockholders of a solvent debtor when less than a majority of any class of outstanding stock refuses to accept the plan. It is conceivable of course that refusal to accept the plan by one or more classes of claimants would make its operation impracticable. Such refusal might even result in the liquidation of the debtor's assets rather than in reorganization.

**Protective Committees.**—It is possible under Chapter X for protective committees to operate under very great restrictions, in comparison with their power under equity receiverships. In the first place, the

judge may examine and disregard any provision of a deposit agreement, proxy, power or warrant of attorney, trust mortgage, trust indenture, or deed of trust, or committee or other authorization, by the terms of which an agent, attorney, indenture trustee, or committee purports to represent any creditor or stockholder, may enforce an accounting thereunder, may restrain the exercise of any power which he finds to be unfair or not consistent with public policy and may limit any claim or stock acquired by such person or committees in contemplation or in the course of the proceeding under this chapter to the actual consideration paid therefor.

The compensation, costs, and expenses of any "indenture trustees, depositories, reorganization managers, and committees or representatives of creditors or stockholders" are subject to approval by the court. Any such representatives may not take part in any proceedings under Chapter X until they have satisfied the court that they have "complied with all applicable laws." On the other hand, the court may allow "reasonable compensation for services rendered and reimbursement for proper costs and expenses incurred by creditors and stockholders, and the attorneys for any of them" in connection with the submission of suggestions concerning or of objections to the plans.

**Appraisal.**—It is too early to make final comparisons of the operation of Chapter X with the procedure under equity receiverships. A few more

years of experience will aid in comparing them. The controls exercised by the court in the former case are much more definite than in the latter. On paper it seems desirable to insist upon a disinterested trustee and that his attorney be disinterested also. However the tests of disinterestedness are as follows: (1) He must not be a creditor or a stockholder of the debtor. (2) He must not have been an underwriter of any of the debtor's outstanding securities within 5 years prior to the date of filing the petition. (3) Within 2 years prior to the date of filing he must not have been a director, officer, or employee of the debtor or of any underwriter of its securities, or an attorney for either the debtor or the underwriter. (4) He must not have any direct or indirect relationship that would give him an interest in the debtor or the underwriter or an interest materially adverse to any class of creditors or stockholders. These are negative and express disqualifications rather than qualifications. Except for these limitations, there appears to be no conclusive reason to think that trustees will rank higher in ability or integrity than equity receivers.

It will be interesting to see whether creditors and stockholders accept the invitation to advise, make suggestions to, and raise objections against the plans of trustees. Certainly the protective committees will hesitate to incur obligations that the court may not sanction. If creditors and stockholders on their own account take the initiative in trying to protect their own interests, it will be a marked change from past experience. Even the invitation to present bills for costs, expenses, and compensation may not induce general participation by interested parties.

At the outset one wonders whether the courts will become sufficiently acquainted with the details of proposed plans to add much to the recommendations of trustees selected by them. To be sure the law imposes upon the court the duty to find a particular plan to be "fair and equitable and feasible" before he can approve it. But will the court be a rubber-stamp for its trustee, or will he use his own independent judgment?

Chapter X takes a long stride in the direction of substituting judicial bureaucracy for business judgment. The issues involved in any plan will involve not only law but economics, finance, market analysis, forecasting ability, and other capacities that courts may not possess in specialized degree. To be sure many cases presented to courts for judicial review involve such issues. But under Chapter X, the burden placed upon the court involves business policy making and its administration rather than judicial review.

The evils of the reorganization procedure under equity receivership are measurable and known. Let us hope that Chapter X will help to correct them. If experience under this law demonstrates the need for changes, let us hope that they can be made speedily and courageously.

**Chapter XI.**—Chapter XI of the Chandler Act provides a method of compromising debts of small insolvent debtors. Only companies with unse-

cured debt may make use of this chapter and then only on the initiative of the debtor. In fact this chapter provides primarily for the relief of the debtor, with the consent of the creditors. While still maintaining his control over the business, under the supervision of the court, the debtor initiates a plan for compromising his financial obligations and submits the same to his creditors for acceptance or rejection. Acceptance of any such plan is subject to confirmation by the court which must find that "it is for the best interests of the creditors" and that "it is fair and equitable and feasible." Chapter XI is not likely to be used in cases where Chapter X would seem to be required.

### QUESTIONS AND SUGGESTIONS

1. Who appoints equity receivers? Who may be selected? Distinguish between a friendly and an unfriendly receiver.
2. What are coreceiverships? Why are they used?
3. What are the duties and responsibilities of receivers? What part do stockholders and directors play during receiverships?
4. What are receivers' certificates? Why are they used? What priorities may be given them?
5. State the advantages of receiverships.
6. In what manner is the receiver concerned with the final settlement of the affairs of the failed business?
7. What is a protective committee, and who appoints it? May such a committee misrepresent rather than represent its clients? Explain.
8. What are deposit agreements, and why are they used? What are their possible weaknesses?
9. Define the position occupied by the average investor with respect to protective committees.
10. What are the functions of protective committees?
11. What are the functions of reconstruction committees?
12. What kinds of dissenters must be dealt with? How can each kind be handled?
13. What was the background of the Chandler Act?
14. How does the theory of Chapter X of the Chandler Act differ from that upon which equity receiverships are based?
15. Who may file a petition under Chapter X?
16. What are the functions of trustees?
17. What part do protective committees play under the Chandler Act?
18. What part does the Securities and Exchange Commission play under this law?
19. What part does the court play in formulating a plan of settlement?
20. How are dissenters dealt with under the Chandler Act?

### SUPPLEMENTARY READINGS

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Securities and Exchange Commission: "Report on the Study and Investigation of the Work, Activities, Personnel and Functions of Protective and Reorganization Committees" (Washington: 1936-1940).

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### SUBJECTS FOR INVESTIGATION

1. Find two examples of equity receivership. Find out all you can about each of them.
2. Find an example of the use of Chapter X of the Chandler Act. Find out all you can about it.
3. Review the latest annual report of the Securities and Exchange Commission to find what part it is playing in the administration of the Chandler Act.

## CHAPTER XLIII

### REORGANIZATION EFFECTS

**Priorities.**—In the formulation of any reorganization plan, it is assumed that the priorities of existing claims will be observed in establishing new relationships. This does not mean that the forms of the claims will remain as they were before the failure. By definition, failure implies an inability to satisfy the forms of claims at the time of its admission. But the number one claimant against the assets of the corporation is supposed to retain his order of precedence over all other claimants in existence at the time the failure occurred. Where the adoption of reorganization plans has been left entirely to voluntary action of the interested parties, the better bargaining ability of the representatives of junior security holders has sometimes resulted in giving them priority over the holders of claims senior to theirs. Even where equity receivers have been in control of the assets of the failed corporation, the court has seldom raised questions about the maintenance of relative priorities, so long as all parties agreed to the reorganization plan.

**Court Attitude.**—Whenever courts have been asked by dissenters to a reorganization plan to review the question of priorities, they have insisted upon the maintenance of the original order of precedence of claims. This was clearly established by the Supreme Court of the United States in the famous *Boyd* case, adjudicated in 1913. In this case the stockholders of the Northern Pacific R.R. Co. were permitted to have a part in the reorganization plan while the unsecured creditors were disregarded completely. The court ruled that the new company must assume responsibility for the payment of the unsecured debts for which the reorganization plan made no provision.

Under Chapter X of the Federal Bankruptcy Act, discussed in the preceding chapter, it is apparent that the rule of priorities enunciated in the *Boyd* case is still the law of the land. Here the court must assume responsibility for reorganization plans, even though they have the approval of creditors concerned. While creditors are asked to express their approval or disapproval, the court is not bound to accept the decision of the creditors. Indeed the court is prohibited from giving its sanction to any plan of reorganization that it does not find to be "fair and equitable." To be sure what is "fair and equitable" in a particular situation is a matter that the court must decide. At any rate, reorganization plans formulated under Chapter X must observe the order of priorities as herein defined.

**Economics.**—In addition to the order of legal priorities to be observed in the formulation of reorganization plans, there are the practical questions of economics and of business expediency which must be raised and answered. Even the Chandler Act recognized this when it provides that the new claims set up under the plan of reorganization must be “in accordance with sound business and accounting practice.” As a consequence, while priorities are to be observed, it is usually expected that the form of the claims will be materially altered in the reorganization plan. This means that contracts are modified or abrogated and new relationships established. Since priorities are relative, the modification of one contract may not disturb the order of precedence of the parties to it, provided that other contractual obligations receive similar treatment. Whether the new plan of operation results from voluntary agreements or from court action, questions of economic expediency receive primary consideration. Legal arrangements merely see that the results are “fair and equitable” to all parties concerned.

**Order of Priority.**—In rare instances, the only change needed is new management. In such cases, security holders and general creditors would not be affected. Such instances are so rare that they may be disregarded. In nearly every instance of corporate failure, new money is needed to rehabilitate the fixed assets of the corporation, to renew its depleted circulating capital, to pay off at least a part of its debts, and to meet the expenses of reconstruction. The need for new capital affects the equities of owners and creditors of the corporation and causes some or all of them to undergo sacrifices when the reconstruction plan is made effective. Subject to bargaining ability, the claimants from whom sacrifices are expected may be listed in reverse order as follows:

1. Government claims for taxes.
2. Creditors holding claims for expenses of reconstruction.
3. Holders of securities not in default.
4. Owners of receivers' or trustees' certificates.
5. Senior-mortgage bondholders.
6. Junior-mortgage bondholders.
7. Unsecured creditors with preferential claims.
8. General creditors without preferential claims.
9. Preferred stockholders.
10. Common stockholders.

**Tax Claims.**—Tax claims take precedence over all other claims. Seldom are they compromised where it is apparent that the assets will liquidate for enough to meet them. Extension of time for their payment may be granted. But if necessary, delinquent taxes may be collected from the sale of the assets of the failed corporation, under the provisions of the laws of the jurisdiction in which the taxes are delinquent. In case of a tax sale, or of a foreclosure sale brought under other auspices, the tax collector is the prior claimant



1932, the receivers for the Seaboard Air Line Ry. Co. issued 3-year receivers' certificates to refund those maturing at that time; in 1935, further 3-year certificates were issued to refund those issued in 1932.

**Senior-mortgage Bonds.**—The position of senior-mortgage bondholders is determined by their legal claims to priority, the bargaining power of their representatives on committees, and the value of the property that secures their claims. A senior lien against a property that the receiver or the trustee may elect to abandon might be in a precarious position. An underlying mortgage on indispensable property is in a very different position. Sacrifices exacted of senior-lien holders may include one or more of the following:

1. *Priority of Claim on Assets.*—In case new money is raised through the sale of prior-lien bonds, holders of outstanding first mortgage bonds may be asked to waive priority in favor of the new issue.

2. *Rate of Interest.*—Where fixed charges are higher than the earnings of the corporation can justify, holders of senior-lien mortgage bonds are sometimes forced to accept reductions in rates of interest at least for a time. The debentures of the Gruen Watch Co., issued in 1935, pay interest at the rate of 2 per cent for the first year; 2½ per cent for the second; 3 per cent for the third; 4 per cent for the fourth; and 5 per cent thereafter until maturity. In 1933, the bondholders' committee of the Security Materials Co. agreed to a plan of adjustment under which the first mortgage sinking-fund gold 7s would be paid 3 per cent to 1934; 4 to 1935; and 6 thereafter to maturity in 1944, extended from 1939. In 1936, the company defaulted on this adjusted plan, and the committee recommended a new plan calling for reduction of principal to 50 per cent and an extension of the reduced amount to 1950 and for an annual interest rate of 5 per cent.

3. *Amount of Principal.*—Sometimes the holders of senior-lien bonds are coerced into accepting a reduction in the amount of the principal of their bonds. This may be in the form of an outright reduction, or they may be given a compensating amount of contingent-charge security such as preferred stock. In 1936, the holders of more than 85 per cent of bonds on deposit with the bondholders' protective committee of the Hammersley Manufacturing Co. agreed to accept an offer to purchase their holdings for \$0.10 on the dollar. It is interesting to note that ahead of the outstanding \$500,000 of this issue were tax claims amounting to \$425,000.

4. *Change of Security.*—If the failure is severe enough, the holders of the senior-lien bonds may be asked to turn them in and accept in their place a weaker security, such as an income bond or a preferred stock. The debenture 5s of the Metropolitan Playhouses, Inc., secured by real estate, mortgage, and other collateral, were issued in exchange for notes of the predecessor company on the following basis: for each \$1,000 note, \$200 cash, \$550 in debentures, and four shares of Class B stock. On consummation of a plan of reorganization in 1936, bondholders of the old Colorado Fuel and

Iron Co. were given for each \$1,000 bond \$400 of Colorado Fuel and Iron Corp. 5 per cent income mortgage bonds due 1970 and 20 shares of no-par common stock.

**Junior-mortgage Bonds.**—Holders of junior-mortgage bonds are usually expected to make sacrifices at the time new plans for financing the corporation are made. In adjusting the financial plan of the Tampa Union Terminal Co. in 1933, holders of sinking-fund debenture gold 7s agreed to the execution of any supplemental indenture that may seem necessary or advisable. The debenture holders were given additional protection by the deposit in escrow of five shares of the company's common stock for each \$1,000 debenture deposited. This stock was to be held in escrow for 10 years from the date the readjustment plan became operative.

In addition to the possible sacrifices listed for senior bondholders, any or all of which may be applied to junior bonds, the latter may be asked to make even more definite sacrifices. Exchange of junior-mortgage bonds for income bonds, preferred stock, or even common stock is a common practice. If the junior-mortgage bonds are covered only by property that may be abandoned without serious loss to the operating efficiency of the revived corporation, or if they have relatively large amounts of underlying mortgages ahead of them, holders may even be asked to meet an assessment as the price of participating in the reconstruction plan.

All bondholders always have the alternative of taking their chances as general creditors, after the proceeds from the sale of mortgaged property have been applied toward the satisfaction of their claims. Their position as general creditors may or may not be of value to them.

**Creditors with Preferential Claims.**—Creditors of the receiver who have furnished materials for operation, similar creditors of public-service corporations and railroads for a brief period—6 months—before failure is admitted, and laborers in some jurisdictions are given preference even over bondholders. They are usually paid in cash, though they may be induced to accept securities in part payment at least. Laws establish other preferences. Bank depositors have preference over other creditors, for instance. Judgment creditors have preference over unsecured creditors who have not secured such validation of their claims.

The position of unsecured creditors with preferential claims is difficult to state. Those with preference over bondholders may usually be fully assured of the receipt of cash in full, if they insist upon it. The status of the 6 months' rule is not clearly defined. In general, it is based upon a recognition by the Supreme Court that, in the case of railroads and public utilities, current debt should be paid out of current income before any payments are made to other claimants, even the holders of mortgage bonds, since this is the only means by which continuous and uninterrupted operation of the property may be assured. As an outgrowth of this conception, the 6 months' rule

gives to certain prereceivership claims an absolute priority over other unsecured debts and a qualified priority over secured debts. The conditions necessary to establish this preference are as follows: (1) The claim must originate from ordinary current expense incurred to keep the operation going. (2) The debt must be contracted with full expectation of being paid out of current earnings. (3) The claim must originate within a brief time (6 months) prior to the appointment of the receiver. These conditions invite dispute and litigation.<sup>1</sup>

Those that follow bondholders may find nothing to divide after the holders of secured claims have been dealt with. They can force foreclosure sale of assets if they see fit but may not benefit from it. They are usually invited to participate in reconstruction plans through the acceptance of some form of funding of their claims. As an inducement to such participation, they may be offered part cash and part stock or bonds for their claims. They may even be asked to meet assessments, though this is not common except in the form of extension of additional credit to the corporation. Relatively, they possess an advantage over unsecured creditors without preferential claims. This may mean much or little.

**Creditors without Preferential Claims.**—Unsecured creditors with no preferential claims are classed as general creditors. They are limited not only by the amount of such claims in relation to liquidation values of assets remaining after secured claims have been given their preferences, but the unsatisfied portion of the latter is added to the claims of unsecured creditors. Deficiency judgment holders become general creditors on a par with all other general creditors. The treatment received by general creditors parallels that accorded to holders of unsecured preferential claims, except for the limitations suggested in the preceding paragraph. Since they are only a short step ahead of the stockholders who, incidentally, may play considerable part in the framing of reconstruction plans, they are not usually given too liberal treatment. Frequently, they are not articulate in protecting their interests because they are not well organized. As already indicated, however, they may not be omitted from any reconstruction plan without their consent.

**Leases and Contracts.**—It is expected that a receiver or a trustee will, as soon as he becomes acquainted with the property that he is expected to manage, determine which contracts to fulfill and which leases to maintain. If he decides to continue to use property made available to him under a lease, he must compensate its owner. If he decides instead to return the property to its owner, there still remains the question of payment for the unexpired term of the lease. While it seems clear that a receiver or a trustee may abrogate a lease or cancel a contract, there is still the settlement with the other party to the contract or the lessor to be taken care of. Prob-

<sup>1</sup> Fitz Gibbon, T. O'C., *The Present Status of the Six Months' Rule*, *Columbia Law Review*, February, 1934, pp. 230-254.

ably most courts would hold that such claimants would have no case as against the claims of secured creditors but that their claims might and probably would take precedence over those of stockholders. In other words, whenever stockholders are made parties to a reorganization plan, lease and contract obligations may have to be considered also. The amount collectible by the injured party would probably be limited to the damages that he could prove.

The measure of damages on the rejection of contracts, used in ordinary bankruptcy, is the difference between the contract price and the price at which the subject matter of the contract could have been sold at the time when the petition was filed . . . The amount of the landlord's claim for the loss of his lease is the difference between the rental value of the remainder of the term and the rent reserved, both discounted to present worth.<sup>1</sup>

**Preferred Stock.**—In reconstruction programs, preferred stock does not always possess the advantage over common stock that their respective positions might seem to indicate. Frequently, neither has much at stake except the speculative chance of recovery of the corporation after reconstruction. Foreclosure sale would usually wipe out the equities of both common and preferred stockholders, not parties to a plan of reconstruction. Because both have only speculative chances at future successes, hesitant stockholders who have not deposited their securities are sometimes invited to participate in the new plan even after it has been formulated. Another reason why preferred stock may not receive a high degree of preferential treatment in reconstruction plans is that common stockholders are usually better organized and better represented than preferred. The bargaining advantage rests with the former.

Preferred stockholders may be asked to subordinate their claims to principal and income through the exchange of their preferred stock for common. They may be coerced into agreeing to a new issue of prior preference stock, to rank ahead of their own claims. Sometimes they are given part preferred and part common in exchange for their old stock. Accumulated dividends on preferred stock are usually funded into some form of stock or bonds at the time of reconstruction. The form of the obligation, and even its existence, depends in large part upon the bargaining power of the representatives of the preferred stockholders. Assessments of preferred stockholders are common.

**Common Stock.**—Common stockholders are the residual claimants against the assets of the corporation. As such, they are the ones that can be eliminated first by foreclosure sales. Their equities suffer most by failures. Therefore, they are always expected to meet assessments as the price of continued participation in the affairs of the corporation. Bondhold-

<sup>1</sup>L. D. Swanstrom, "Chapter Ten" (Chicago, 1938), p. 115.

ers, however, seldom exercise their rights to freeze out stockholders. Two reasons account for this: (1) The stockholders are looked to as one source of new capital; and (2) the bondholders seldom want to assume responsibility for active management of the corporation. Their willingness to carry along the stockholders for this purpose tempers the treatment that the latter receive.

Common stockholders may expect two things from reconstruction plans: (1) a reduction in their number of shares; and (2) some form of assessment. Some of the old stock may be taken from the common stockholders and given to the holders of the preferred in exchange for the holdings of the latter. If a new corporation is organized, holders of old common stock will usually be given a smaller amount of new stock, provided that they meet the assessments charged against them. Recent reconstruction plans have made use of stock purchase warrants, giving to contributing stockholders rights to purchase stock in the future under stipulated conditions.

**Assessments.**—Under the old form of collecting additional money from stockholders and bondholders, assessments were levied in such manner that the attention of the contributor was centered upon the mistakes of the past. In the 1875 reorganization of the Erie R.R., common stockholders who paid an assessment of \$4 per share received their stock back; if they paid \$6, they received in addition income bonds equal to the amount of their assessments. Preferred stockholders were assessed, on the same basis, \$2 and \$3, respectively. In effect, reconstruction committees said to those from whom contributions were expected something like the following: "Your corporation is in bad financial condition. As a matter of fact, the situation is so bad that there is a fair chance that you will lose everything you have invested in it. The demand for money to pay the expenses of reconstruction, to meet the claims of creditors who threaten foreclosure sale, to rehabilitate worn-out and obsolete fixed capital, and to provide needed circulating capital is great. The supply of money from the usual sources is cut off. You alone can save your present investment by meeting assessments on your present holdings. If you do, you can protect your present investment. If you do not, you will lose it through foreclosure sale."

**Subscription.**—The psychology of assessments is weak. The emphasis is upon past mistakes. More recent reconstruction plans have changed the technique. Assessments on present holdings have given place to subscriptions to new, well-protected securities. The holder of stock, or of junior-mortgage bonds, is approached in such manner that his attention is centered upon the promise of the future instead of the mistakes of the past. Instead of the sad tale related above, he hears something like the following: "We admit that your investment to date has been somewhat of a disappointment. That is water under the bridge. The future will be different. Our chances for recovery and for continued progress are excellent. In fact, they are so

good that we must expand in order to take advantage of them. We need additional fixed capital and a large amount of circulating capital. We propose to raise this by the sale of high-grade bonds. Naturally we are offering first opportunity to purchase these bonds to present security holders. In order that all may have equal opportunity to participate in this offering, we are allotting to each stockholder an amount of new bonds proportionate to the amount of stock held by him. You own X shares of stock. Your privilege of purchase of the new bonds is \$Y."

If the bait is effective, nothing further need be said. If for any reason it fails to bring forth the necessary cash in exchange for the subscription to the bonds, the stuffed club of threat of foreclosure may be called into use. Patience and good salesmanship are used in approaching the subject even then.

The recent plan for the reorganization of the Wabash Ry. contains a combination of assessments, bait for those who paid it, and punishment for those who did not. It provides for a \$7 assessment against each share of preferred and common stock. Stockholders who pay the assessment are to receive an equivalent face value of 4½ per cent income bonds. In addition, each share of Class A preferred stock that meets the assessment will be exchanged for one share of new no-par common stock; each share of Class B preferred, for one-half share of new no-par common; and each share of existing common, for one-third share of new no-par common. For those stocks not meeting the assessment, the exchange ratios are as follows: Class A preferred, one-third share new no-par common; Class B preferred, one-sixth share new no-par common; and common, one-ninth share new no-par common.

**Expediency.**—Whether assessments or subscriptions are employed, rules of expediency govern the action of individual stockholders and bondholders expected to make contributions of new capital. Willingness to play the game may be overcome by inability to supply the cash required. Some may be forced to sacrifice present equities, since they cannot meet assessments or participate in subscriptions. Others weigh the chances of future success against the amount of new contributions expected of them. Their decision governs their action. This is always a limiting factor in making assessments. If the stockholders are assessed too heavily, they will refuse to meet the demands. Bondholders may be called upon to bear a part of the burden which would break the confidence of the stockholders if placed upon them alone.

**Underwriting Assessments.**—Syndicates are frequently organized to pay assessments of those who do not choose to participate in the reconstruction plan. They take over the stock of such holders as well. Underwriting of the plan is necessary, for the plan cannot be put into effect unless all interested parties participate in it. Then, too, if any securities are to be offered

to outsiders, they are usually underwritten, and perhaps sold, by the same syndicate. The commission paid to the syndicate attempts to measure the risk undertaken. If the risk is too great, no syndicate would underwrite it. The fact that a syndicate is employed will help some timid and uncertain security holders to decide that they should participate in the reconstruction plan.

**Warrants.**—With the introduction of the idea embodied in stock purchase warrants, together with the practice of more drastic reorganizations in the last few years, the assessments of stockholders and others have ceased to be common. If the remedy needed suggests that there is no equity left for common stockholders, the old stock is cancelled, and in its place former holders are given warrants to buy stock of the new corporation at specified prices for a specified period of time. Depending upon the length of the period of time for which these warrants are usable by their holders, the stockholders may recover some of their losses if the new corporation demonstrates its earning capacities within the life of the warrants. This is true even though the amounts asked of the holders of the warrants should be greater than the current value of the stock at the time the warrants are issued. Meantime, in order to make sure that the new money needed by the new corporation will be available, new securities are offered to whoever will buy them, perhaps with the use of an underwriting syndicate.

**Management.**—One additional feature of reorganization under the Chandler Act deserves brief notice. In the first place, Chapter X prohibits the issuance of nonvoting stock and provides that voting power in the new corporation shall be equitably distributed. Then in recognition of the need for competent and honest management, if the new corporation is to have a proper chance for success, the Act provides that the manner of selecting its management, as set forth in the reorganization plan, shall serve the interests of the investors and shall be consistent with public policy. Finally, the act places upon the court the responsibility for determining whether a continuation of the old management or the selection of a specific new management appears to be in the interests of the investors and to be consistent with public policy. While the court cannot be held responsible for his approval of the management, at least these provisions of the law center attention upon the need for public approval of the initial management of the new corporation. There is apparently no reason why the court might not select a voting trust to manage the corporation if it saw fit to do so. However, it does not appear likely that voting trusts will longer be commonly used for this purpose, since they are looked upon as temporary in nature.

**Foreclosure Sale.**—Although it is likely that resort will be had most frequently to Chapter X when a corporation admits failure, it is still possible to use the older process of foreclosing a defaulted mortgage debt. In such case the representatives of the holders of the first lien that is in default will

foreclose their mortgage and ask the court for a judicial sale of the property to obtain funds to satisfy the mortgage. If the creditors' claim is unsecured, they must first obtain judgment and then attach the corporation's property to satisfy their judgment. In either case, foreclosure sale follows. After an investigation of the value of the property to be sold, the court advertises a public auction of the property and fixes an "upset" price which is the lowest bid that the court will entertain at the sale. In a sense, the "upset" price protects the minorities which may not be parties to the demand for the sale.

The committee that holds the bonds of the issue which initiates the sale is usually the successful bidder for the property. It can turn in the bonds in lieu of cash to cover most of its bid price. All other bidders would be required to pay cash. The committee must put up only enough cash to meet the prorata shares of the minority who do not join in the purchase, to pay the costs of foreclosure, and to pay accumulated taxes and other prior claims. Should the successful bidder be the holders of the prior-mortgage bonds, it will obtain the property free and clear of all encumbrances, provided that it has joined all other claimants against the property in the suit to foreclose. Junior claimants are wiped out if they fail to make a successful bid for the property. If the successful bidders are the holders of a junior claim—in case one or more senior claims are not in default—the buyers assume the obligations of all claims prior to their own. If, perchance, some outside party should buy the property for cash at the foreclosure sale, the proceeds would be distributed by the court to claimants against the selling corporation in the order of their priority. Whoever buys the assets at foreclosure sale organizes a new corporation to hold the property, and the old one is dissolved.

**Dissolution of Corporations.**—Formerly, it was expected that when a business enterprise suffered a failure so serious in character that its stockholders had no equity left it should dissolve completely. Under Chapter X, any business, regardless of the nature or extent of its obligations, can be reorganized if the court finds that the petition for relief of the debtors has been filed in good faith. While the new plan may leave no place for the stockholders of the old corporation, reorganization may nevertheless follow. The other alternative for an insolvent corporation is to liquidate and dissolve. Liquidation means the disposal of the assets, and dissolution means the surrender of the corporation's charter. Liquidation may take place when the corporation sells its assets in bulk or when it disposes of them in some other manner. Dissolution may or may not follow the liquidation of any particular list of assets.

**Solvent Corporations.**—Solvent corporations may liquidate their assets either voluntarily or involuntarily. Where the owners of a business decide to retire from active business or to change the nature of their operations, they may dispose of their assets by selling them as a unit or in any other



manner. Partial liquidation may occur when only a part of the assets are disposed of. Involuntary liquidations result from a variety of causes. The charter of the corporation may have expired and for some reason cannot be renewed. Or the charter may be revoked because the managers have committed an *ultra vires* act. Or some other law may have been violated, necessitating the dissolution of the corporation. Some corporations may not be permitted to dissolve, whatever their desires. A railroad or a public utility must continue to operate unless approval for dissolution is obtained from the appropriate regulatory authority.

The procedure to be followed in the voluntary dissolutions of corporations is prescribed in the corporation codes of the various states. In general the pattern is this: The officers recommend dissolution proceedings to the directors. Should the latter agree, the question is submitted to the stockholders at a regular or a special meeting. It is customary to require a two-thirds vote of the stockholders to sanction the dissolution of the corporation, though in a minority of states a majority is sufficient. The charter-granting authority is then notified of the intent to surrender the charter. Creditors are notified to file their claims. After verification, they are paid off from the proceeds of the sale of the assets, or else they are otherwise satisfied. Corporations may not dissolve without first satisfying their creditors in some manner. In case some of the creditors have secured claims, such as mortgage bonds, it is likely that the purchaser of the mortgaged assets will assume the obligations of the bonds. At any rate, the mortgage claim follows the assets. General creditors and the deficiency claims of mortgage creditors, if any, must be satisfied from the proceeds of the sale of assets that are not mortgaged or from the excess of value over secured claims.

After the creditors are satisfied, any remaining assets are distributed among the stockholders. All preferential claims are expected to be observed. For example, preferred stockholders are expected to be paid first, including the redemption value of their stock—which may include a premium in case of voluntary liquidation of the corporation—and any accumulated dividends. After creditors and preferred stockholders have been cared for, all remaining assets belong to the common stockholders and are distributed pro rata among them. Thereafter, the charter-granting authority is notified that the liquidation proceedings have been consummated and a dissolution certificate is granted, thereby ending the life of the corporation.

**Insolvent Corporations.**—When corporations become hopelessly insolvent, they are expected to wind up their affairs and quit business. Liberal as Chapter X of the Chandler Act is in its encouragement of corporate reorganizations, it cannot be used where “it is unreasonable to expect that a plan of reorganization can be effected,” or where “a prior proceeding is pending in any court and it appears that the interests of creditors and stockholders would be best subserved in such prior proceeding.”

Liquidation of the assets of insolvent corporations may follow any one of several patterns. Where all the creditors agree, the simplest and usually the least expensive procedure is by private arrangement between the debtor corporation and its creditors. Here there are three possibilities. The owners of the business may dispose of its assets and turn the proceeds over to the creditors. In effect, the owners are trustees for the creditors. It is frequently difficult to get all creditors to agree to this plan. The assets may be assigned to a representative of the creditors or to adjustment bureaus sponsored by the National Association of Credit Men.

**Assignments.**—The debtor may take the initiative and assign all or a part of his assets to an assignee, who may distribute the assets among the creditors or dispose of them in order that the proceeds may be so distributed. State and Federal courts recognize the right of debtors to assign their assets for the benefit of creditors, except where such action is taken in order to defeat bankruptcy laws. This form of settling with creditors is similar to bankruptcy proceedings but differs in important details. Only creditors need receive notice of assignments in their favor. The disposition of the deposited assets is left to the discretion of the assignee and the creditors. Orderly, rather than forced, liquidation may realize a higher price for the assets. Assignment expenses are decidedly less than those incurred in bankruptcy proceedings.

**Legal Control.**—The insolvency laws of the various states provide for the recording of assignments in the office of the county clerk in the county in which the debtor resides or conducts his business. Assignees are answerable to insolvency judges, who may assist as follows by:

1. Approving composition settlements.
2. Accepting the filing of suits for the recovery of property transferred to defraud creditors.
3. Preventing debtors or witnesses from leaving their jurisdictions.
4. Approving payment of liquidation dividends.

**Duties of Assignees.**—Assignees are usually appointed by the debtor. Frequently he selects one of his creditors. Aside from formal duties of filing notices, giving bond, etc., the assignee's chief duties may be listed as follows:

1. To sell the assets entrusted to him.
2. To collect debts due the assignor.
3. To pay the liquidation expenses and distribute the remainder of the proceeds among the creditors. Liquidation dividends are declared from time to time as the funds become available.
4. Should there be anything left after all expenses of liquidation are met and all creditors are paid in full, it must be turned over to the assignor.

**Weaknesses of Assignments.**—Since the administration of assignments depends in part upon the consent of the creditors, they lack the authority of finality possessed by bankruptcies. Since assignment in itself is an act of

bankruptcy, creditors dissatisfied with assignment progress may file a petition in bankruptcy. Like most questions about which the different states exercise the right to legislate, there is no uniformity among the states, either in laws governing assignments or in court decisions affecting them. Furthermore, the jurisdiction of the laws and court decisions of any state cannot extend beyond state lines. Action of creditors in one state cannot bind decisions of those in another jurisdiction. Because the Federal bankruptcy act takes precedence over all state laws on the subject of insolvency, the assignee cannot give a debtor complete release from his obligations without the consent of every creditor. Assignments usually apply to relatively small business enterprises whose liabilities are, for the most part, in unfunded form.

**Bankruptcy.**—"Successful" bankruptcies are badges of crookedness. If a business manager can, by the use of bankruptcy proceedings, be absolved from further obligations to his creditors and, at the same time, retain in some manner assets that the creditors cannot reach, he is said to be a successful bankrupt. Not all bankrupts are crooks. The prevalence of risk in business, and of failures to gauge properly its amount, forms the basis for bankruptcy laws which recognize that greater justice may be attained by relief of debtors from their burdens than by discouraging them from undertaking further productive efforts. States have insolvency laws, but they are frequently ignored because of the availability in many cases of the more comprehensive Federal bankruptcy law.

**Uses.**—Bankruptcy laws are utilized at times only as a last resort in dealing with debtors. It is the most expensive method of dealing with cases of total insolvency. Yet there are instances in which no other method will prove effective. This is particularly true where there is a suspicion of fraud or where it is necessary to take legal means to recover property that has been concealed, or transferred, for the purpose of defeating creditors. After passing into equity receivership in 1932, the International Match Corp. filed a voluntary petition in bankruptcy 6 days later, stating that it had outstanding \$97,000,000 in debenture bonds and that its business was in a chaotic condition as a result of the death of Ivor Kreuger and the ensuing exposure of the mishandling of the Kreuger companies.

**Bankruptcy Law.**—The Federal bankruptcy law is intended to afford relief to creditors similar to that afforded by the state insolvency laws. In one very important respect, the former differs from the latter. The bankruptcy law discharges proved debts (except those due the United States) and debtors, while the insolvency laws alone accomplish no such purpose. Under the latter, debtors are still liable to pay their debts in full unless relieved therefrom by the creditors. The bankruptcy law has essentially two purposes to serve: (1) to assure a proper distribution of the proceeds from the sale of assets among the creditors so that none may have unfair advantage

over others; and (2) to relieve unfortunate but honest debtors from further obligation.

Insolvency and bankruptcy are sometimes confused. Inability of a debtor to pay his debts makes him insolvent. Bankruptcy refers only to the formal act of reference to the Federal bankruptcy law as the means of settling the difficulties of the debtor.

**Types of Bankruptcy.**—When a debtor asks that he be judged a bankrupt in order that he may enjoy the relief afforded by the law, he is designated a voluntary bankrupt. If other means are available for dealing with creditors, they should be resorted to in preference to bankruptcy because of the expense involved and the stigma that attaches to the term. When one or more creditors take the initiative in petitioning that the debtor be declared bankrupt, the process is termed involuntary bankruptcy.

**Acts of Bankruptcy.**—Without formal application for bankruptcy, specific acts of the debtor, while insolvent, may lead to the same result. They are as follows:

1. Conveyance or concealment of property for the purpose of defrauding creditors. Intent to defraud must be proved with reasonable certainty.
2. Transfer of property by the debtor in such manner as to give one or more creditors a preference over other creditors. Such preference must be intentional and be acquiesced in by the preferred creditors. Payments made in due course of business operations do not constitute a preference.
3. Permitting creditors to obtain such preference by legal proceedings and taking no immediate action to cancel such preference. Debtors who permit liens and judgments to be filed against them are said to commit passive acts of bankruptcy. Such references are voidable by the trustee in bankruptcy.
4. A general assignment for the benefit of creditors or the appointment of a receiver, or trustee, to take over the property of the debtor. State insolvency laws are overridden by the Federal bankruptcy act by this means.
5. Admission in writing of inability to pay debts and expression of willingness to be declared bankrupt on that ground. Such an admission amounts essentially to voluntary bankruptcy.

**Bankruptcy Proceedings.**—There are certain limitations to the application of the Federal bankruptcy act that need not concern us here. Omitting these, the proceedings in bankruptcy involve the following steps:

1. The petition is filed, by either the debtor or the creditors, with the Federal district court.
2. The court holds a trial, adjudges the debtor a bankrupt, and directs a referee to administer the case.
3. The referee calls a meeting of creditors, at which time the bankrupt may be examined, and the creditors are given opportunity to prove their claims and to elect a trustee.

4. In urgent cases, the court may appoint a receiver at the time the debtor is declared bankrupt.

**Duties of Referee.**—Referees in bankruptcy are appointed by bankruptcy courts for 2-year terms and are removable at their discretion. This makes them distinctly the agents of the court. Their duties are as follows:

1. To examine schedules of property filed by bankrupts and lists of creditors and to cause changes to be made when necessary.

2. To serve as an information bureau for all parties interested in a bankruptcy case.

3. To compile all records in bankruptcy proceedings.

4. To declare dividends and to deliver to trustees complete information about all such distributions.

**Duties of Trustee.**—The trustee is the agent of the creditors and may be chosen by them. Three may be chosen instead of one if such is desired. In case the creditors fail to elect a trustee, he may be appointed by the court. His functions may be outlined as follows:

1. To collect and convert into cash the assets of the debtor.

2. To pay dividends declared by the referee.

3. To account to the creditors for all receipts and expenditures.

Upon qualification, the trustee is vested by law with title to all assets of the bankrupt, including documents, interests in patents, and rights of all kinds, except such exemptions as are allowed by law.

**Duties of Receiver.**—Where there is immediate danger of decrease in the value of assets, if retained in the possession of the debtor, either through waste, neglect, or fraud, the court may appoint a receiver in bankruptcy to take over control of the debtor's property. His tenure of office may expire as soon as a trustee is elected and qualified. Either debtor or creditors may ask for the appointment of a receiver. In many instances, the receiver appointed by the court is continued as trustee by the creditors. Since time is frequently the essence of success in bankruptcy proceedings, the receiver may be a very important cog in the machine intended to protect the interests of creditors. It is his duty to collect the assets of the debtor, including books and records, and to conserve them in the interests of all concerned.

**Standing Receiver.**—The Federal bankruptcy law is based upon the principle that the assets of an insolvent business enterprise should be administered and disposed of by the creditors and their representative, the trustee. The receiver is but a temporary officer to be succeeded by the trustee. Because the creditors do not act promptly to protect their interests and because of the frequent use of bankruptcy proceedings in New York, the Federal court for the southern district in that state in 1929 appointed a standing receiver to act in all bankruptcy cases. Pending the appointment of a trustee in a particular case, this receiver proceeds to collect accounts

receivable, prepares legal papers, disposes of merchandise, prepares statements of assets, and pays current expenses.<sup>1</sup>

**Priorities.**—In the distribution of the proceeds of the debtor's assets, the following order is observed:

1. Taxes.
2. Costs of administration of the bankruptcy proceedings.
3. Wages, with some limitations as to time and amounts.
4. Creditors entitled to preference.
5. Creditors without preference.

Discharge in bankruptcy releases the debtor from all provable debts except taxes and certain obligations resulting from his fraudulent acts.

Upon approval by the court, a composition may be effected by which the debtor secures the consent of his creditors to accept less than their claims and give the debtor full discharge from further obligations. A majority in number of the creditors whose claims have been allowed by the court may approve a composition. Upon proof of fraud, the court may set aside a composition at any time within 6 months of its date.

**Penalties.**—In order to protect the administration of the bankruptcy law against the acts of dishonest persons, heavy penalties may be imposed upon debtors, creditors, officers, or others who try to defeat or obstruct the operations of bankruptcy proceedings by false statements, concealments, destruction of records, or other illegal acts.

**Disadvantages of Bankruptcy.**—Unless fraud is present, the debtor can obtain discharge of his obligations by "going into bankruptcy." Creditors are not usually so fortunate. The sale of assets of the debtor by a trustee usually brings very low prices at public auction. The cost of administration absorbs a large part of the proceeds from the sale of assets. Because it is usually recognized that if the failure of the enterprise is sufficiently serious to warrant resort to bankruptcy proceedings there will not be enough left to satisfy all creditors, the latter do not cooperate in settling the affairs of the bankrupt. Instead, each tries to obtain an advantage over the others. As a result, the liquidation dividends of bankruptcies are very low. Unsecured creditors who receive more than 10 per cent of their claims may consider themselves fortunate. Many creditors, recognizing their small chance of recovery, pay no attention to bankruptcy proceedings and thus lose their small equities.

**Dissolution to Follow.**—Assignments and bankruptcies are usually followed by dissolution of the corporations involved. The Ohio corporation code provides that a corporation may wind up its affairs and dissolve when it "has been adjudged to be a bankrupt, or has made a general assignment for

<sup>1</sup>Oettinger, J. S., *The Standing Receiver—A Major Step in Bankruptcy Reform*, *Harvard Business Review*, October, 1931, pp. 109-117.

the benefit of creditors, or, by leave of the court, when a receiver has been appointed in a general creditors' suit or any suit in which the affairs of the corporation are to be wound up, or when substantially all of the assets have been sold at judicial sale or otherwise." The court may order the dissolution of a corporation when it appears "that its property and assets are insufficient to pay all just demands for which it is liable, or to afford reasonable security to those who may deal with it."

### QUESTIONS AND SUGGESTIONS

1. What is the meaning of priorities? How are they observed in reorganization procedures?
2. Does this mean that only the weakest claimants are expected to make sacrifices? Explain.
3. Does it mean that no change will be made in the form of obligations to the strongest claimants? Explain.
4. Which claim comes first? What are the chances of compromise here?
5. What kinds of securities may not be in default? What happens to them when settlements are reached?
6. What happens to receivers' and trustees' certificates? To senior-mortgage bonds? To junior-mortgage bonds?
7. What unsecured creditors may have preferential claims? What happens to such claims?
8. How are claims without preference handled? What happens to leases and other contracts?
9. What happens to preferred stock? To common?
10. How are warrants used in reorganizations?
11. What does the Chandler Act do about managements of failed corporations?
12. What is a foreclosure sale, and when is it used?
13. How can a solvent corporation dissolve?
14. How may an insolvent corporation effect a voluntary dissolution?
15. What is an assignment? What are its weaknesses?
16. Define bankruptcy. Why is it used? What are acts of bankruptcy? What happens when any of them are committed?
17. Define the duties of the officials connected with bankruptcy.
18. What happens to the proceeds of the sale of assets under bankruptcy?
19. What are the advantages and the disadvantages of a resort to bankruptcy?

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## SUBJECTS FOR INVESTIGATION

1. From recent issues of the *Commercial and Financial Chronicle*, find a corporation that has reconstructed its financial plan as a result of failure and point out what changes have been made.
2. What sacrifices were made by each class of security holders and by general creditors?
3. Do you think the changes made are likely to prove effective in creating a successful corporation? Why?



## PART VII

### SOCIAL CONTROL

#### CHAPTER XLIV

#### STATEMENT OF THE PROBLEM

**Restatement.**—Perhaps this chapter and the one to follow will appear to the reader to be merely a repetition of various statements in the preceding chapters. Nevertheless, a restatement of the problem of social control of business corporations seems justified. The main question that we face is not “Shall we have social control?” but rather “How much control shall we have?” Those of us who believe in maintaining as much of the advantages of private enterprise as possible see in the business corporation a means of potentially great service to all our people for the indefinite future, provided that its excesses are not permitted to become the cause for its strangulation. Friends of private enterprise must possess patience, perspective, and persistence. The reader of this text who has borne with the author thus far is asked to exhibit a bit more patience in reading these last two chapters in the hope that he may add to his perspective and—we trust—be encouraged to persist in his faith in the essential virtues of our present economic order in spite of the mounting criticisms of its mistakes. The genius of American business leadership has created a monument worth preserving. Let us not permit its detractors to tear down their accomplishments until we are sure what will take its place.

**Implications of Social Control.**—Our faith in “rugged individualism” is sometimes subjected to severe strains. When fortuitous circumstances permit the fruition of our plans, we accept credit for our successes. But when crises arrive, we try to establish alibis for our mistakes and are glad of the opportunity to shift responsibility for their correction to others. The impotence of the individual, unaided by group action, becomes a matter of common acceptance under such circumstances. All sorts of plans for social control are then proposed. This does not mean that Americans have surrendered their faith in individualism. Instead, social control is accepted as an aid to, rather than a substitute for, individualism. We seek group action in order to release the individual from his fetters so that he may enjoy greater personal freedom.

**Growing Uneasiness about Corporate Control.**—With the increasing concentration of control of business enterprise and its perplexing complications and with the narrowing of investment opportunities in business to the purchase of corporate securities, there is bound to be increasing questioning of the responsibility of corporate control and the possible need for interference by public agencies with the hitherto unmolested private affairs of business enterprises. Students of corporation finance must acquaint themselves with the implications of the growing uneasiness about corporate control, for they will be relied upon from time to time to help in the solution of problems created thereby. We must face the facts and follow wherever they lead. Refusal to admit them must result in undesirable solutions dictated by special interests, either corporate or anticorporate.

Serious students of the problem are becoming more articulate in clarifying the issues involved. One commentator has presented the question so clearly that his observation bears quotation. He says:

Fundamentally, the devices of corporate finance in all their fantastic and bewildering array represent, still, to a marked degree the response of legal and financial technicians to the demand of large-scale production for a capital and control mechanism commensurate with its basic needs. That the response has been overgenerous and that much of it is calculated to minister to perversions as well as basic needs—opening of new avenues for the reaping of gains from “maneuvering” as distinct from producing—is obvious; that it could not well have been otherwise is equally clear. Viewed in the light of its inspiration and origin, its rapid and almost frenzied “coming of age” and the combination of indifference and open-mouthed credulity with which, until very recently, it has been received, the whole growth of the corporation and its devices takes on, most convincingly, a “man-made” cast.

Emphasis on the corporation as a mechanism or tool carries the implication that within the limits of practical adjustment we can retain as much of the corporation as seems good to us, and can get rid of the rest; we can make our own rearrangements, internally and externally; and if the good (*e.g.*, technological efficiency) and the bad (*e.g.*, dangerous concentration of power) in the corporation seem inseparable, we are still free to decide whether the former is worth the price, and to act accordingly.<sup>1</sup>

Through the use of corporate devices, American industry has made rapid strides in the development of resources and in building up high standards of living. The very rapidity of development must necessarily have brought in its wake weaknesses to which more and more attention will be given as they become more apparent. The outstanding weaknesses of the corporate system are discussed in this chapter.

<sup>1</sup>Lewis, Ben W., Berle and Means on the Modern Corporation, *Journal of Political Economy*, August, 1935, pp. 553-554.

**Attacks upon Corporation Procedure.**—The attacks upon corporation procedure have increased in intensity and in volume in recent years. They emanate from many sources. It is easy to build a case against many common practices. Whole books, some written in catchword phrases, vie for attention in this field. The chapter headings of a recent outburst are suggestive:

1. Believe It or Not.
2. The Parade of Camouflaged Corporate Profits.
3. Stratospherical Compensation.
4. Light Literature. (Corporate reports.)
5. What Chance Has the Stockholder? (Confusion of consolidated figures.)
6. Aladdin and His Wonderful Lamp. (Corporate net profits.)
7. What Re-appraisals Mean to the Stockholder. (Writing up and writing down.)
8. Side Stepping Accounting. (Reserve for contingencies.)
9. Weak Kneed Accounting.
10. The Forgotten Man. (Stockholder.)
11. The Symbol of Capitalistic Liberalism. (Corporate annual report.)<sup>1</sup>

Writing in the *University of Pennsylvania Law Review*,<sup>2</sup> H. G. Reuschlein says:

The corporation has long been regarded as the sick man of our economy. . . . It has been singled out by social engineers and social tinkerers (including lawyers) for special study. A list of the ills and symptoms besetting the corporate device would make a bulky catalogue indeed. Among those which have most disturbed sociologists, economists and even the lawyers are: (1) the unhappy divorce of corporate control from corporate ownership; (2) the activities of promoters who profit unfairly; (3) the presence of directors who do not direct; (4) the use of the one man company; (5) the cancerous growth of intercorporate shareholding; (6) the practice of stock watering; (7) the curse of bigness and its attendant concentration of economic power; (8) more or less irresponsible charter-mongering; and (9) the unsatisfactory relations with labor.

**Corporation Codes.**—Forty-eight states vie with each other in concocting laws governing the organization of corporations. Some states may be classed as "anticorporate" in the sense that their legislation is framed primarily by agricultural and other group interests not particularly concerned about favors to corporations. Such states are apt to have somewhat strict corporation codes. This does not always follow, however, since a few of the agricultural states have very liberal codes. States whose legislatures are dominated primarily by industrial interests usually have liberal, even lax, corporation codes. Some of these make a "business" of incorporating companies and take pride in the fact that the "revenues" from incorporation fees

<sup>1</sup> Winthrop, Alden, "Are You a Stockholder?" New York, 1937.

<sup>2</sup> October, 1942, p. 91.

and franchise taxes make other types of taxation unnecessary. The corporation "business" of the state supplies the funds for operating the state government.

The keen competition for this "business" has resulted in considerable shopping around by corporate promoters and attorneys, before determining the state in which to incorporate. In many instances, the advantages of both economy of fees and liberality of privileges recommend some state other than the one in which the business of the corporation is to be conducted.

**Freedom from Interference.**—States differ in the amount of charges against the corporation for fees and taxes and in the freedom from interference by the state with the affairs of the corporation. Also, general corporation legislation affecting subsequent operation of business enterprises varies greatly. A few states permit practices that invite control by corporate managers in such manner as to work to the disadvantage of stockholders and creditors. Such legislation is usually justified on the ground that, if the rights of others are being unreasonably usurped or overridden by corporate directors and officers, the courts can be resorted to for redress of grievances. Experience does not support the idea that courts will be commonly appealed to. Undoubtedly, they stand ready to correct many abuses now common, if stockholders and creditors would only seek their aid.

**Reasons for Lack of Uniformity.**—The reasons for the lack of uniformity and consistency in state corporation codes are various. State sovereignty is a right to be jealously guarded. Acceptance of a common code on any question seems to imply surrender of a part of such sovereignty. Independence is a wonderful blessing even if it does result in making sport of its possessors. More sincere differences of opinion result from differences in conditions. The problems of the older sections of the industrial East are not always like those faced by the newer agricultural sections of the West. They tend to become more common as the conditions behind them develop similarities. Legislatures are usually dominated by lawyers, who see the legal side of questions but who are not always too well informed about other sides. Corporation problems are, in part, questions of law. Primarily, they are questions of economics. Incidentally, they may become more and more questions of political theory and social organization. Lawyers need advice from others in attempting to solve corporate problems. Even courts are inclined to emphasize unduly the legal technicalities involved in corporate organization and control. A careful survey of some laws on the subject of corporations makes one wonder whether the framers thereof are anything more than the tools of the interests they serve.

**Stockholder Weaknesses.**—The student of corporation finance can hardly come to the conclusion that the stockholder is wholly powerless in protecting his own interests. He must admit, however, that such power as exists is latent. Some day the sleeping giant may awake in time to slay those who

defraud him. The reasons why such action has not already occurred are numerous and include the following:

1. Most stockholders lack experience. They are new at the game of stock ownership. Hence they are easily led. They accept form for substance and are bewildered when they find themselves facing disappointment.

2. The myriad unorganized small stockholders forces upon each a realization of his incompetence to deal with problems beyond his comprehension.

3. The average stockholder has no basis for judgment in rating investments in stock and in discriminating among the opportunities open to him. He is showered with tips, but sound measures of value are lacking.

4. The stockholder has no reliable source of advice. His lack of experience prevents him from distinguishing between tips and sound judgment. Having followed the former to his sorrow, he does not know where to turn to find the latter. Even the most careful investigations of impartial and competent advising agencies prove inadequate at the time accuracy and completeness are most needed.

5. Perhaps, too, many prospective stockholders do not know what investment policy they should adopt. Slow savings and accumulation at a low interest rate fail to appeal to many investors. Purchase of stock is a gamble that promises unusual gain and carries a thrill of achievement as long as it appears to be successful. Americans are not only stockminded, they are speculatively minded. Stock speculation possesses a "kick" that no other sort of investment offers. Unfortunately, the "kick" that the speculator receives is not always the one he expected.

6. The impersonal relations of stockholders in a corporation leave each with no feeling of responsibility toward the others. Each acts according to what seems to be his own best interest. Short selling in the hope of driving down the price of the stock is undertaken with no thought of the possible effects upon holders of other shares of the same stock. There is not only a lack of common defense among stockholders as a class, even the stockholders of a single corporation recognize no common interests to bind them together.

7. As a consequence of the above, stockholders are apathetic toward initiating any program of self-protection and are indifferent to plans proposed by others. They buy stock that they think is cheap, cash such dividend checks as come their way, give careful attention to the stock ticker and its record in the daily press, and express their dissatisfaction with the affairs of their corporation by selling their stock.

**Lack of Information.**—Stockholders cannot hope to possess corporate intelligence until they have available information about the affairs of corporations in which they are, or may become, interested. Corporate information at present is not conducive to stockholder intelligence for several reasons:

1. In many cases, there is an utter lack of published information. Such statements as are given out by officers and directors of some corporations represent opinions that have a propaganda purpose behind them. They are not intended to instruct stockholders but to induce such action or inaction as may be desired by those who express the opinions.

2. Lack of uniformity of reports makes comparison among investment opportunities difficult. It is not contended that reports of all corporations can be cut to the same pattern. Neither would anyone seriously support the heterogeneous manner of presenting information now available.

3. Stockholders are frequently handicapped by delay in securing information. Monthly earnings of American railroads are available to the public about 6 weeks in arrears; to insiders, about 1 week in arrears. Careful and fairly accurate estimates are available to the latter sometimes 3 weeks in advance. Industrial corporations commonly report to stockholders annually, several months after the close of the fiscal year. Months and even as much as a year may elapse between the occurrence of an important event in the life of a corporation and the notice of such event to the stockholders. By the time such information reaches the mass of stockholders, the effects of the event may have been discounted by those in a position to know about it long before it comes to the attention of the majority of the stockholders.

4. An applicant for a job as junior accountant was asked if he was familiar with double-entry bookkeeping. "Oh my, yes," he responded; "where I worked we used triple-entry records: one for the directors and officers, one for the income-tax collector, and one for the stockholders." This confession has common application. Whether stockholders should be given all the information available to officers and directors is a debatable question. There are good arguments against it. Nevertheless, the information given to stockholders is often incomplete and inadequate. It does not afford a proper basis for judgment about the progress of the corporation.

5. Brief reports to stockholders are frequently confusing. Condensed income statements may combine operating income with nonrecurring financial income, for instance. As a consequence, conclusions drawn from brief, condensed statements are not always reliable.

6. Accounting reports are frequently defective. They lack precision and completeness. Depreciation charges, for example, are frequently either too high or too low. Whether the fault is due to the accounting department or whether the latter is merely executing the orders of "higher-ups," the effects upon the stockholders are the same. Whatever insiders may know about the affairs of the corporation, others are limited to the published records. Defective records do not always carry evidence to condemn them.

7. Someday a corporation report may be not only accurate and complete, but may also disclose the methods of valuation used in the tabulations

quoted. So-called facts are subject to interpretation. Figures do not lie, but liars figure. With the best of intentions, every statistical and accounting entry represents the opinion of someone, more or less qualified to render it. These opinions are reflected in valuations which become the bases for decisions. Methods of valuation become exceedingly important to those who make the decisions.

8. One of the best investments that a corporation can make is the purchase of the services of a well and favorably known firm of public accountants to make an independent audit, to be submitted to stockholders. It protects both the management and the stockholders. If it is what it should be, it will afford the latter more information than they are likely to receive otherwise, and it procures for the former the sanction of independent and impartial investigators of their records.

**Dilution of Shares.**—By statute, charter, and waiver of rights by stockholders, boards of directors acquire the power to authorize the issuance of additional shares of stock not representing a contribution to corporate capital equivalent to that owned by existing shareholders. Various mechanisms are used to accomplish this purpose, including manipulation of paid-in surplus and exchange of shares in case of merger.

**Promotion.**—Much of the growing dissatisfaction with corporate enterprise attaches to the promoter and his operations. The reasons for this may be summarized as follows:

1. It is so easy to obtain a charter for the organization of a corporation in America that every Tom, Dick, and Harry is invited to play the game of promoter. Inexperience, shady reputation, or lack of financial backing is no bar to attempting the sale of all sorts of securities to unwary investors.

2. The promoter has all the advantage over the security purchaser in the kind of contract offered. The former may and usually does secure the services of competent legal talent who knows all the tricks of the trade. As a consequence, charters may be quite complex and beyond the comprehension of the average stockholder.

3. Promoters usually have only a speculative interest in the enterprises they promote. "Sell out and get out" is frequently their motto. Their profit comes from a successful disposition of the corporation's securities, not from successful operation of the business. Their plans are made to fit their opportunities.

4. Dishonest methods of promoting corporations are not unknown. Unless some injured party takes the initiative to secure redress, there is usually none to stay the hand of the promoter of crooked securities.

5. Promoter's profits are frequently excessive. Whenever the promoter can control the board of directors of the corporation, he can secure their approval to any contract he desires to present to them. Various indirect means can be used to ensure large profits to him and his associates.

6. Secret profits by promoters are frowned upon by law but must be discovered and proved before they can be prevented. In the absence of police protection, many things happen that are illegal.

7. The promoter may follow various practices to mislead the stock purchaser during the progress of sale of his securities. Manipulation of the market may give a false idea of values of the securities offered for sale.

**Financial Management.**—Financial managements of corporations sometimes work to the disadvantage of one or more of the various classes of claimants against the corporate earnings and assets. There are always conflicts of interest among these groups of claimants. Creditors may be harmed by financial policies that benefit stockholders. The interests of preferred stockholders may be sacrificed in favor of the common stockholders. The chief weaknesses of financial management may be summarized as follows:

1. The financial plans of many American corporations are unduly complex. The complexity may be unintentional and result largely from rapid growth. Nevertheless, its existence complicates financial policies and works hardship upon one or more groups of security holders.

2. Overcapitalization is a common weakness of American corporations. In itself, this would not be objectionable, provided all securities were of one class—common stock—and provided further that all such stock had been disposed of at its true value. The presence of fixed charges and preferential payments makes overcapitalization a serious problem in many corporations.

3. Dividend policies are sometimes dictated by motives other than the return of a fair income upon investment. They are sometimes used in such manner that gain to one group is possible only through corresponding loss to another.

4. Paying dividends out of capital that is disguised as surplus is particularly reprehensible. Creditors suffer by this process, and even the recipients of the dividends may lose in the long run by such practices.

5. Various devices may permit the financial management of a corporation to withhold earnings from those properly entitled to them. Holders of noncumulative preferred stock and income bonds are frequent victims of a management dominated by common-stock interests.

6. It is easy to dilute corporate equities through the sale of new securities, particularly those carrying conversion rights and stock purchase warrants. Even though preemptive rights are always observed by the management of the corporation, inexperience of the original holders and other reasons may prevent them from protecting their own interests.

7. The value of conversion rights and stock purchase warrants in turn is frequently diluted by the use of large stock dividends and stock split-ups.

8. Financial management is in a position to direct the conservation or dilution of equities in mergers and consolidations. Subject always to orga-



nized opposition by groups of security holders, which seldom develops, the management may agree to plans which favor one or another interest in the corporation, with a reasonable expectation that the plan will be approved by all concerned.

9. Reconstruction of corporations may produce similar results. Valuable rights may be contracted away under the advice of financial managements, acting either mistakenly, but in good faith, or from ulterior motives.

**Administrative Abuses.**—The trust fund theory under which corporate capital is supposed to be conserved for the benefit of creditors seems quite well established in law, though in practice it is observed partly in the breach thereof. There is a growing sentiment for considering directors and officers as stewards entrusted with the responsibility of protecting the interests of stockholders as well as creditors. As yet, however, such ideas have not passed much beyond the sentiment stage. At present, officers and directors are invited to practice many administrative abuses, including the following:

1. The fiction of the corporate entity serves as a convenient screen to hide the actions of the individuals who make up the official family of the corporation. A common defense may be briefly stated: "The corporation authorized that action—not I."

2. The wide diffusion of ownership of voting stock, the use of the proxy, and other devices to be described later, make a change of control of a corporation very difficult. In spite of the desires of others, an entrenched control may maintain its position except under very unusual circumstances.

3. Management alone is permitted to use the resources of the corporation to allocate control. At the expense of the corporation, it solicits proxies to ensure its perpetuation in control. No other group has this privilege.

4. The theory of corporate directorship is that each director shall be chosen because he is able to contribute something to the management of the corporate business. In practice, one-man control is common, the other directors being dummies, ready to do his bidding and possessing no independent judgment.

5. Instead of accepting the responsibility that directorship imposes upon them, some boards and board members use every means at hand to avoid responsibility. Some of these may be legal and others not illegal merely because no one hales them into court to prove their illegality.

6. Some directors and officers are not merely passive in avoiding responsibility, but, through negligence, breach of duty, *ultra vires* acts, or conversion, they act in such manner that only the lack of initiative and the indifference of injured parties prevent them from being held liable for damages resulting from their acts.

7. Whenever directors and officers have no substantial financial interest in the operating success of the corporation which they control and manage,

they cannot be depended upon to give to its affairs that care and attention necessary to protect its security holders and creditors.

8. Lack of substantial investment may turn the attention of those in control to the possibilities of milking the earnings of the corporation through high salaries and bonuses.

9. Personal interests of the directors and officers are not always consistent with the interests of stockholders and creditors. For example, if the former are short sellers of the corporation's stock, they may wish its price to decline. This wish may be translated into reality through their own acts.

10. Interlocking directorates permit abuses in the control of corporations. Minority or even majority interests may be defeated by intercorporate control of policies in the interests of other corporations.

11. Not all administrative abuses are violations of expected legal practices. Corporate charters are so framed at times that they supply immunity baths for directors and officers. In other words, the charters themselves permit practices that seem quite foreign to either good morals or decent business ethics. Under the guise of freedom of contract, charters give directors the right to dilute equities by various means and to use their official connection with the corporation to further their personal interests.

12. Stockholders, who scarcely know the meaning of the terms used, are induced to waive certain rights, such as the preemptive right to subscribe to new issues of stock. This waiver may be written into the charter or may be contained in a separate contract.

13. Directors and officers usually have at their beck and call the best legal talent to advise them and to protect their interests. The expense is borne by the corporation. Objectors to the management policies usually must pay for their own legal advice and services.

14. Whether sanctioned by law or not, corporate managements may authorize manipulation of the books of account so that only those who possess the key can unlock their secrets. Not all manipulation is undertaken with fraudulent intent. Such practices give insiders tremendous advantages.

15. Meantime, the poorly defined legal rights of stockholders to inspect books and records are further nullified by obstructive tactics of unfair managements. Although not completely able to defeat the rights of stockholders, managements may discourage attempts to inspect books and virtually nullify the legal rights.

16. When so inclined, those in control of corporate affairs may commit frauds which may never be detected by injured parties. Covering up is made easy and detection difficult by various administrative abuses which, *per se*, may not be illegal. A preliminary report of the commission appointed to investigate the affairs of Kreuger and Toll Co. indicated that "under the personal direction of the late Mr. Kreuger" assets were inflated, liabilities

understated, fictitious entries were made, and general juggling of accounts among various affiliated companies was indulged in.

**Control Devices.**—Control of a corporation means the right to determine its policies. It may be exercised directly in the selection of directors, in amending the charter, and in ratifying acts of directors who, in emergencies, acted without specific authority. Control may be exercised indirectly through threats to remove directors who refuse to play the game according to the rules set forth by those in control. Or it may be exercised negatively by the sale of voting stock to others who have an interest in positive control. In theory, a corporation is a democratic institution where majorities rule. In practice, the franchise may be limited or wholly nullified by various control devices.

In theory, stockholders are expected, by their active participation, to chart the course for their corporation to follow. In practice, most owners of voting stock exercise their franchise either neutrally, by not voting at all, or passively, by transferring their voting rights to others. As a consequence, it is not difficult for the owners of a minority of the stock of a corporation to exercise control over its affairs. With a wide distribution of shares, the minority in control may become synonymous with the management group so that, with a surprisingly small ownership of stock, it may become self-perpetuating. Had it the ethics imputed to professional groups and had it the capacity for expert management, little objection could be raised against this stage of corporate evolution. Unfortunately, the interests of ownership and control are not always the same. The latter is in a position to assert itself in the face of an inarticulate and unorganized group of corporate owners.

**Minority Control.**—The devices by which minorities, whether of stockholders or of managers, are enabled to control corporations may be listed briefly as follows:

1. Bondholders normally possess no rights to vote. While they are considered at law as creditors, the line between creditorship and ownership is not easily drawn. To the extent that capital is contributed by nonvoting bondholders, the control of the total investment of the corporation is reduced in scope.

2. Nonvoting stock bears to control a relationship similar to that of bonds. It may have contingent or veto control, described elsewhere in this volume. The Fox Theatres Corp. was authorized in 1936 to issue 7,400,000 shares of Class A no-par common stock, nonvoting, and 100 shares of Class B no-par common stock having exclusive voting rights. The two classes of stock were identical in all other respects.

3. The common use of the proxy deprives even voting stockholders of their active participation and makes them mere passive witnesses to minority control.

4. Wide distribution of shares prohibits effective organization of stockholders, were they inclined to cooperate. At best, such stockholders furnish ammunition to warring minorities fighting for control.

5. Whatever the rights of the stock held by ordinary stockholders, management stock sometimes possesses what amounts to multiple voting rights. By this means, a dollar's worth of stock in the hands of management may outvote several dollars' worth voted by outsiders.

6. Voting trusts, elsewhere described, permit concentration of control for definite purposes or for specific periods.

7. Pyramiding permits the control of one corporation through ownership of the controlling stock in another. If the process is repeated several times, particularly if each corporation's capital is represented in part by bonds and nonvoting stock, a small ownership may exercise a great control.

8. Any device that removes from the market part of the stocks with voting rights, and thereafter causes such stock to be not voted, tends toward concentration of control of the corporation. Purchase of stocks by institutions, such as investment trusts, may have this effect.

**Speculation.**—One of the outstanding weaknesses of the present corporate setup grows out of the interest that managements have in security speculation. Some directors and officers staunchly resist opportunities for speculative profits and stick to their business of producing and distributing goods and services. Others succumb to the wiles of the stock market and divide their time, attention, and energies between the work of the corporation, for which they are selected, and their private interests in security price fluctuations. If such members of the official family of a corporation should confine their speculative activity to stocks entirely unrelated to the corporation in which they are interested, less objection could be raised to such activities. It is natural to expect them to speculate in the securities of a corporation about which they possess most knowledge. Some directors feel that their inside information about the affairs of their corporation is their compensation for being a director at a nominal fee. Hence they feel free to capitalize such information as they see fit. Even on this basis they could hardly justify the "rigging" of corporate reports and the rumors that sometimes facilitate their speculative activity at the expense of other equity holders. Nor could they sustain manipulation of accounts and even of corporate operations that are intended to influence market changes.

**Negative Approach.**—Many reformers, with a flair for remaking the world, habitually lack imagination. They idealize a dim and distant past and long for the return of conditions that probably never existed. Seldom are they anxious to take advantage of all the lessons of history and to build upon the foundations of existing institutions. The tearing-down process always seems necessary as a preliminary to the rebuilding program. Freedom and independence are always the watchwords of reform. It would

appear that, from time to time, these precious blessings are wrested from tyrants of one sort or another only to be stolen again by new enemies of the public weal, so that the wresting process has to start all over again. Occasionally a student of social progress takes for granted this continuous struggle against oppressors and views oppressors and oppressed as parts of a whole, which together furnish the material for social evolution. This concept at least possesses the merit of suggesting abandonment of quests for the fountain of youth and of studying diet, exercise, and sleeping habits as the means of prolonging life.

Specifically applied to the field of business, the evolution of business control raises doubts about the desirability of returning to the good old days of any idealized past. As a matter of history, from the time business replaced other forms of control to become a major pastime of Western civilization, it has been characterized by leaders and followers. So-called "pure democracy" has never been powerful in business or in politics. Neither has any real meaning except in terms of control by the few who work their way to the top or are floated thereto by fortuitous circumstances. Business, like politics, in a democratic organization always finds a place for the individual who can outrun the herd. Neither American politics nor American business has held out many favors to those born with silver spoons in their mouths. Many individuals have choked to death on hereditary silverware.

**Meaning of Social Control.**—The term "social" calls for careful definition. Society is a nebulous concept, much misunderstood. It implies ideas and ideals held in common. If all people ever thought alike or attempted to act in common on any particular subject, that subject has not yet been discovered. Society—meaning the totality of individuals—is in a constant state of flux, dotted here and there with concentration points. The fluidity of the mass causes constant shifting of points with the resultant disappearance of some and the creation of new ones. These concentration points represent group interest. Society is a conglomeration of groups, appearing and disappearing, growing in size and strength and declining by turns, combining with other groups and separating therefrom.

Social control, therefore, as used in this text, means group control. At one time, one group may be uppermost in power; and, at another time, a different group may gain control. Different groups cooperate for common purposes and at times form new groups. Individuals belong to several non-competing groups at the same time. They have as coworkers in one group individuals who become rivals in another grouping. Groups having the same objective in mind follow different routes to the same goal. Some of the agencies discussed have ideas and ideals very different from those of other agencies.

**Control over Security Issues.**—Most of the agencies for social control of corporations are interested primarily in security issues. Few make any

direct attempts to test honesty and ability of managements or to interfere with what may be termed internal problems of the corporation. Indeed, most agencies do not even attempt to direct external relationships except negatively; *i.e.*, sanction is withheld unless the standards set up by the agency are met. If the corporation wishes to push its plans in the absence of such sanction, it is usually permitted to do so.

**Complexity of Corporate Problems.**—From what has been said above, it is evident that the problems of American corporation finance have no simple solution. Complex situations are never so favored. So far as possible, they must be resolved into their elements, and each part must receive the treatment necessary for its solution. No one would seriously contend that all is well with American corporation finance and that there is nothing to be done. On the other hand, no one should insist upon acceptance of substitutes for present practices unless he can give reasonable assurance that they will correct rather than aggravate existing weaknesses. If we are told that communism must succeed capitalism, we have a right to ask, "What will succeed communism?" Who can demonstrate that the disadvantages of a communistic system of economics would not outweigh the weaknesses of the capitalistic system under which we operate? Surely the latter is not wholly bad.

**Abortion of Corporate Purposes.**—The corporation is the most effective form of business organization yet devised for facilitating the production and distribution of goods and services. So long as it is used primarily to further the plans of production and distribution, its range of opportunity for social good is unlimited. Unfortunately, its elements of strength can be turned to uses that frequently result in individual gain at the expense of others. Divisibility of ownership and transferability of shares enable small investors to participate in its benefits. They also lead to financial abuses which have • already been discussed. Whenever a corporation ceases to be primarily an agency for facilitating production and distribution and becomes a vehicle for carrying selfish interests over the welfare of the group, it represents an abortion of the purposes for which the corporation was organized. If it is to avoid the condemnation of its critics, it must be diverted from such practices.

**Limitations of Social Control.**—To date, no one has devised a workable scheme for preventing or correcting all the weaknesses of corporations discussed in this chapter. Perhaps there can be no such scheme. Most of our legislation and other forms of social control are aimed at fraudulent practices of promoters and security salesmen. Ignorance and indifference of security holders and inefficiency of corporate managers are problems apparently too difficult for legislatures and regulatory commissions to solve. In essence, they are human traits which everyone possesses in greater or less degree. Propounders of panaceas who fail to take account of them are sooner or later classified as fanatics or impractical dreamers.

**Ownership Ineptitude.**—Stockholders and bondholders are about as useful to the management of the average corporation as the bricks in their buildings. Their tangible contributions are necessary to the success of the corporation. Beyond that, the average security holder contributes little more than the bricks. (An occasional exception proves the rule; General Foods Corp. reports that suggestions for many new products were received from stockholders.) A part of the ineptitude is undoubtedly due to the feeling of futility experienced by the typical stockholder. The increasing complexity of corporate relationships has reduced his opportunity to control his investment; at the same time, it has added to his confusion about his rights and the way to protect them. He does not even register complaints when he is dissatisfied with the management. He sells his security, if his dissatisfaction becomes acute, and bets his money on another horse. Corporate weaknesses cannot hope to be substantially corrected until stock- and bondholders acquire not only intelligence and information but an active interest in the affairs of the corporations in which they have a financial interest.

Furthermore, stockholders particularly, and even some bondholders, will need to acquire sufficient mental maturity to cause them to question the existence of a Santa Claus. In their private business conduct, they have long since learned not to expect something for nothing. They must learn that the hocus-pocus methods used by some corporation managers to create wealth are chiefly hocus-pocus. Speculative fever is a virulent disease. Until its ravages are at least checked, there can be no correction of many corporate weaknesses.

### QUESTIONS AND SUGGESTIONS

1. Is it likely that social control of corporations will increase or decrease in the future? Explain.
2. Under what kind of economic circumstances is there the greatest demand for social control?
3. Summarize the common criticisms of business corporations.
4. How do corporation codes of the various states complicate the problem of control of corporations? Account for the differences among codes.
5. What are the outstanding stockholder weaknesses? Would these disappear if the stockholder had better information? Explain.
6. How does dilution of shares affect control?
7. What are the weaknesses associated with promotion of corporations?
8. List the weaknesses attached to financial management of corporations.
9. List the outstanding administrative abuses.
10. What control devices are common? How is minority control facilitated?
11. How does speculation lead to corporate abuses?
12. What is meant by the negative approach in considering reforms?
13. What do you understand by social control?
14. Which is easier—to control security issues or to correct management weaknesses? Why?

15. Are corporate problems simple or complex? Explain and give examples.
16. What are the limitations of social control?
17. What suggestions have you for overcoming ownership ineptitude?

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#### SUBJECTS FOR INVESTIGATION

1. Summarize the criticisms recently made by a book or an article whose chief purpose was to point out weaknesses in American corporations. With which of these criticisms do you agree? Why?
2. With which do you disagree? Why?
3. Find a financial plan that you consider unduly complex. What would you do to simplify it?



## CHAPTER XLV

### PROPOSALS FOR REFORMS

**Groping for Security.**—One word that has frequently appeared in the thinking of the American people in recent years is "security." Economic planning and stabilization have succeeded the "New Era" talk of a few years ago. This succession is not only chronological but logical. During the "New Era," it was difficult to interest anyone in planning for the future. The future seemed assured without conscious planning.

The aim of a stabilization program is security. When people are optimistic, they do not wish security. We are willing to assume risks provided we see hope for success. When clouds appear upon the economic horizon, in the form of falling prices and increasing unemployment, pessimism succeeds optimism, and a haven of shelter is much desired. Security then becomes our aim. Our unwillingness to assume new risks, or indeed to accept responsibility for the failure to cash in on the risks already assumed, is accompanied by a demand for increased social control of industry. This demand is voiced by all classes. Business leaders ask for relief from restrictive legislation and the right to temper the effects of competition by combination which will limit output, for instance. Labor wants shorter hours, the security of an assured job, and a larger share of the distributable income. Politicians favor increased governmental regulation of economic affairs.

**Stabilization Not New.**—The publicity recently given to this or that "plan" leaves the impression that stabilization programs are new. On the contrary, we have had such programs urged and accepted, in one form or another, over a considerable period of time. Trade-union activity aims at security for union members. Mergers and trade associations have stabilization of industry as an objective. Long ago, we undertook the regulation of railroads and public utilities—first in the interests of shippers and consumers, but latterly for the protection of the industries regulated, as well. The Farm Board took a fling at stabilization of wheat prices. The governor of a southwestern state introduced martial-law economics to peg the price of oil. Another southern state recently passed a law limiting cotton acreage in order to stabilize cotton prices. Some industries have appointed "czars" with power to dictate the conditions necessary for at least a measure of industrial security. And so the list might be extended indefinitely. In fact, any action having as its goal the minimization of risk may properly be classed as a stabilization program.

**Confusion of Term.**—There is much confusion surrounding the use of the term “stabilization,” as recently applied. Some think of it merely as a corrective and include various emergency measures as parts of a stabilization program. Others conceive it to be a preventive of future depressions. They think stabilization of industry would keep it on an even keel from now on. Others see in various “plans” neither correction nor prevention but the hope of an entirely new economic order. Taking their cue from the Five-Year Plan in Russia, with its elimination of capitalistic profits, they profess to find in the adoption of a plan for America the means of redistribution of income and, perhaps, of wealth as well. If the latter group is right, there is bound to be disappointment for that other group which sees in stabilization the salvation of capitalism. The members of this latter group are scared. They think capitalism is on trial, and they fear the verdict of the jury. They hope to settle out of court by the offer of such stabilization as will save capitalism.

**Is the Old Order Passing?**—Prophets of the new order of economic planning profess to find in it not only a new method of economic control but a means of disposing of outworn theories and their supporters. The old economist, it seems, was mistaken in his belief in a benevolent organization of our economic life which promised optimum satisfaction to all through the operation of the doctrine of *laissez faire*—which, by the way, many of us fail to recognize as a means of social control since we have forgotten its origin.

The new order will substitute for individual initiative the dictates of a Federal commission whose blueprints will detail wage scales, hours of work, price levels, and all other elements of the productive and distributive program. The disappearance of the old economics and the old economist may be worth striving for, provided the price we are asked to pay is not too high.<sup>1</sup>

**Wide Variety of Plans.**—Those interested in the general subject of stabilization have a wide variety of “plans” to choose from. Almost every vest pocket carries one. Some offers of social control of industry fully justify the definition of the word “social” adopted in an earlier chapter of this book. They represent merely group interests—so narrow in scope that they can hardly hope to gain many converts outside their own circle. Some are only as wide as the industries they spring from. Their adoption might well aggravate the ills they propose to remedy. The effects of these proposed “plans” upon corporate ownership, management, and control are directly proportional to their scope. Some would have very profound effects upon all three.

**The Unstabilized Past.**—For a century and a half, American industry has passed through kaleidoscopic changes. The “three r’s” of such changes have been radical, rapid, and ruthless. Enterprises and even whole industries

<sup>1</sup>Daniels, W. M., *The Passing of the Old Economist*, *Harvard Business Review*, April, 1934, pp. 297-303.

have been wiped out. Cycles of unemployment have succeeded each other with discouraging regularity. Yet from the havoc wrought by each depression has arisen a more dynamic and progressive industrial structure. The problem that we face today is to preserve the progressiveness and at the same time temper the ruthlessness of change.

**Probable Effects of Stabilization.**—Stabilization “plans,” if successful in operation, would tend to temper the ruthlessness of change, probably at the expense of progressiveness. A highly stabilized system of industrial organization would be neither dynamic nor progressive. The tendency would always be in the direction of static conditions and relationships. Carried to their logical conclusion, stabilization “plans” would result in the adoption of the Russian system—conscription of producers and rationing of consumers.

The adoption of stabilization “plans” generally for all industry would leave little justification for private property and orthodox capitalism. Individual initiative, competition, and the automatic operation of markets—the concomitants of profit economy and capitalism—would disappear. Owners of capital would be divorced from responsibility, and their risk would be minimized. There is only one major difference between a communistic dictatorship such as Russia has chosen and a capitalistic dictatorship which must follow the general adoption of stabilization “plans” in America. That difference is important. If capital ceases to contribute to the development of industry, it should cease to withdraw its fruits. In other words, the adoption of stabilization “plans” on the whole industrial front is an admission of the breakdown of orthodox capitalism and private enterprise.

**Alternatives.**—What, then, are the alternatives that American industrialism faces? They appear to be four in number:

1. We may depend solely upon “rugged individualism” to cure our ills. Although we have long worshiped at this altar, our devotion has been largely in the form of lip service. We talk individualism and vote tariff protection, Eighteenth Amendments, and various other restrictions upon individual activities and discretion.

2. We may follow current pessimistic leanings to the logical conclusion of abandoning hope for improvement under our present system and demand its complete overthrow in order that a second Russian dictatorship may take its place. In the absence of a revolution, not even contemplated by any considerable group, such a change is hardly possible. Two conditions would prevent it. (1) In setting up such a dictatorship, if we follow the usual orderly procedure required for constitutional amendment, passage of enabling legislation, and its adjudication by the courts, the time required to put such a plan into effect would itself be a wonderful healer of existing wounds. (2) More important, it seems hardly possible that the sober common sense of the American people will sanction the substitution for the system under

which they live of an untried one whose chief asset to date is promise—at least until it has been demonstrated that the defects of our present system are beyond repair.

3. It is conceivable that we might rub Aladdin's lamp and witness the emergence of a "plan"—some ingenious scheme that would effect the salvation of our economic souls without punishing us for our sins by establishing a dictator to rule over us. Fortunately, our Yankee ancestors left us the heritage of curiosity about the value of the "gift horse." We insist not only upon looking into his mouth but upon thumping him around a bit before accepting him. None of the "plans" proposed to date will stand much thumping.

4. Finally, we can continue our perpetual inventory of our economic system and pursue our inquiry into the causes of our successes and the reasons for our failures to date. The more we learn, the more humble we become. Our cocksureness goes stale in the presence of great crises. Fallibility of human judgment makes intelligent men cautious about accepting supposed finalities. Americans of today are disposed to emphasize the importance of our own existence. Historically, our generation is but a grain of sand on the shores of time. If we contribute to the solution of the specific problems of our own day, we may well let generations to come wrestle with their problems. Looking backward, we acknowledge our debts to our ancestors and express our thanks that they did not obligate us more by trying to plan our lives for us. Looking forward, we ought to be equally charitable toward our descendants.

By various means and throughout our history, we have been adding to economic security. The paths we have followed have led to corrections of specific weaknesses in our economic system. The net result is that the system itself has been modified materially. We shall probably continue by making such further changes as time and occasion require. The stabilizing process must be continuous unless we content ourselves with stagnation. Stabilization by evolution and "unstabilization" by invention are both consistent with progress.

**Interdependence of Social Controls.**—Most economists have long since buried the economic man. Actions result from a complex of emotions, impulses, and reflexes. They may be described much more easily than they can be explained. Economic questions sometimes find answers in the realm of politics, if at all. The two world wars did not simplify the task of the economist whose theories pointed in the direction of greater international dependence and increasing foreign trade. Nationalism—not only political, but racial, social, intellectual, and economic—has thrown a whole tool chest of monkey wrenches into the international economist's machinery of thought and theory. Such factors must be taken into account in any attempt to understand programs for social control of corporations.

**Fraud.**—Much attention is given to the activities of promoters and security salesmen which result in defrauding those with whom they deal.

This is not a new problem. In 1874, Poor's Railroad Manual (p. lviii) says:

Waterings; speculation in their stocks, which could be raised or depressed at will by those behind the scenes; interest in contracts for construction, or furnishing materials by which companies have often paid double prices for what they have received, have brought to too many, who have been lucky enough to secure their possession, colossal fortunes almost in a day.

The cupidity of the great mass of small investors was almost equally stimulated by offers of rates of interest which promised very speedily to return them the whole capital they invested. The mania thus became almost universal.

In 1884, Poor (p. iii) says:

It is in this immense increase of fictitious capital that is to be found the cause of the general distrust which prevails, and the enormous decline in the price of railroad securities. From 1879 to near the close of 1883 a most singular delusion rested upon the public as to their value, and this delusion was taken advantage of on a vast scale by able and unscrupulous adventurers. Whatever was manufactured and put afloat was seized with avidity by an eager and uninformed public. The delusion was increased and prolonged by payments on a very large scale of interest and dividends from capital. In this delusion the most loud-mouthed and unscrupulous promoters usually had the greatest success.

Perhaps we should revive the jolly old custom of quartering and boiling in oil those whom we consider enemies of the public weal. Fraudulent promoters certainly ought to rate high in a list of social enemies. If we built a vat large enough to contain them all and if we economized fuel by cooking them all at one time, we would still have the cupidity of investors and the stupidity of stockholders to deal with. Until these were abolished, a new crop of promoters would take the risks of another barbecue in order to secure a chance at the profits within their reach from the sale of worthless securities.

**Education.**—A suggestion is made that we abolish stupidity by educational processes. As a member of the educational fraternity, the writer is flattered by the suggestion. But his common sense and experience tell him that even education has limitations. Not everybody is exposed to educational processes of the proper sort. Education is not contained in bottles, with proper labels and directions for taking. All that we experience becomes our teacher. The investment cautions we may learn from bankers and other competent advisers are frequently offset by the ballyhoo of the marketplace brought to our consciousness by many and devious ways.

**Information.**—Some question the necessity of acquiring an education about corporation finance when there is so little opportunity to apply it because of the lack of information about the affairs of any specific corpora-

explaining many of his choices on any other grounds. If we contend that he is not capable of choosing for himself, we undermine the foundations of the democracy that permits him to exercise a choice. If we insist that his choices are influenced by selfish interests, we again impugn his ability to judge for himself after hearing the evidence. If we grant him the right to reach decisions, we must grant him the correlative right to pass upon the admission of evidence. The important fact to note in passing is that, for some reason or reasons, the average man does not use the franchise so much as he could to further his own ends. The rights, the machinery, and the authority necessary for enacting and enforcing the will of the electorate are all present. What more is needed?

If and when the great mass of security holders acquire an intelligent interest in the affairs of their corporations, we may expect to find corporation codes rewritten to protect the interests of investors. Legalized piracy will not then be sanctioned in order that some states may secure in taxes and fees a share of the loot taken from the sale of worthless securities. Without drastic changes in some of our corporation codes, hope for reform is remote. Continuation of some provisions of these laws constitutes a standing invitation to crooked and inexperienced promoters that will not go unheeded so long as there are suckers to bite on succulent bait.

**Other Agencies for Control.**—Nongovernmental agencies for corporate control are always responsive to the expressed wishes of their constituents. Most of these are dependent upon security holders for a living. The consumer may not always be king; but an articulate consumer, who knows what he wants and has the money to pay for it, can render a very good imitation of a ruling authority. Many agencies for social control do not wait for the security holder to awaken to his own interests; they set alarm clocks and wind them frequently whether they are heeded or not.

**Associations.**—Standards of business conduct adopted by such associations as the Investment Bankers Association may have profound influence upon the kinds of securities dealt in by their members. This is purely negative control, since such associations have no authority to regulate the kinds and amounts of securities that may be issued. Through common standards of business conduct, they may merely establish rules of buying and selling to which their members are advised to adhere. In addressing the Bond Club of New York in 1937, the president of the Investment Bankers Association of America defined the responsibilities of the members of his association as follows:

To the issuer we owe good advice as to the raising of capital by simple direct methods that do not cramp the company's future growth, and at a price that is fair. To the investor we owe the presentation, with forthright disclosure of all material facts, of carefully considered investments affording good security and a fair return, the word fair always to be interpreted in the light of prevailing market conditions.

Again, many corporations with small issues of securities of a highly speculative character would never appeal to an investment banker for aid in distributing their stocks and bonds. Hence, the advantages of even negative control could never be extended to them.

**Better Business Bureaus.**—In recent years, the activities of better business bureaus have been directed in part to exposing methods of fraudulent security salesmen. Both prospective investors and legal authorities have been notified of the pitfalls awaiting the purchaser of specific securities.

**Institutional Buyers.**—Institutional purchasers of securities, such as investment trusts, insurance companies, banks, and other financial institutions, exercise a selective control over securities that they purchase. Their willingness to buy one kind and not another and to entrust their funds to one corporation and not another will play considerable part in directing the flow of capital and in developing certain types of industries.

**Investment Counselors.**—As yet investment counselors have only potential power to influence investment policies and trends. If and when the great mass of capitalists comes to a realization of their incompetence to direct their own investment programs, they may turn to investment counselors for advice. Under such circumstances, the latter may acquire a position of influence and power in controlling the flow of capital and the types of corporations to be encouraged.

**Courts.**—In the last analysis, the final source of authority in correcting corporate weaknesses is our judicial system. Slow as it is to adopt changes, it is probably one of the most effective agencies for social control of corporate abuses. Its fundamental principles of justice and right are abiding; its application of them to new conditions is flexible. Under our system of government, courts can neither take the initiative nor sanction experiments with new devices. Judges are human beings who learn from the same teachers as other people. Judge-made law is responsive to changing economic and social needs, albeit judges are hesitant to expound such law until they are sure of their conclusions. This may mean that courts may be quite a distance behind the leaders of economic thought on a particular issue. Before the courts can be useful in correcting abuses, someone else must take the initiative in enlisting their aid.

The law always stands ready, upon invitation, to review the grievances of any individual or group and to offer redress where conditions warrant it. Where definitive statutes do not determine obligations and rights directly, the common law eventually adjusts itself to meet new situations. Patience in waiting for such adjustments is often a virtue sorely needed, but the flexibility of the common law finally asserts itself.

Corporate jurisprudence has established more or less definite rules of conduct which it will insist upon when cases are brought to the attention of the courts. These are as follows:

1. Corporate officers and directors are required to give a reasonable amount of attention to the affairs of the corporation. While negligence is not defined by all courts alike, none is indifferent to its presence.

2. The interests of the corporation demand that those acting for it should always adhere to good faith in their decisions. In a suit filed by minority stockholders of the Beacon Participations, Inc., the court held the directors liable for losses amounting to \$240,991. Whether or not courts will permit an officer or director to protect his own interest while acting for the corporation, it will not sanction acts that evidence failure to render reasonable service to the corporation.

3. Acceptance of the office of director or officer of a corporation is interpreted by the courts to mean that the individual concerned represents himself to possess at least ordinary knowledge and skill and that he will use them in the interests of the corporation.

4. It must not be expected that courts will sanction mere "fishing expeditions." When a bondholder of the Philadelphia and Reading Coal and Iron Co. asked a Federal court to investigate the management but admitted that he had no information indicating mismanagement, the judge signed an order giving the directors "permanent possession" of the company's affairs but provided that, if the complaining bondholder secured any facts upon which to base an investigation, he could ask for the removal of the management and the appointment of trustees.

Courts never take the initiative in correcting abuses. Aggrieved parties must formulate their claim, locate their oppressors, and present evidence to prove their contentions. Thereupon, courts undertake to weigh the evidence, determine blame, and assess penalties. The formalism of court procedure has often discouraged resort to its protection. More frequent appeal to courts for redress of grievances might render unnecessary other forms of social control.

**Objectives.**—In the development of American industry, commerce, and finance, we have all been driving so fast that many of us have never thought to inquire where we are going. The corporation has been such an effective agency of transportation in carrying us along this journey that we have given every applicant a chance to be its chauffeur and even to tinker with its engine. New gadgets have been added from time to time, and all sorts of motor fuels have been tried out. Inexperienced and ill-mannered chauffeurs have driven pell-mell over rough spots, losing passengers and running over pedestrians in the process. In the hilarity of the chase, those of us who have been able to maintain any sort of seat have raised little protest. In fact, we have found the ride quite exciting. Even most of those who lost their seats have been glad to find others as soon as their bruises healed. But not even those who buy the gasoline and pay for repairs seem interested in our destination.



**Private Property an Expedient.**—If private property rights are no longer held sacred, they can be justified only on the grounds of expediency. The interests of the group are paramount to those of the individual who happens to inherit or marry property or even to acquire it by any of the other means sanctioned by law or custom. We permit him to use and manage it because we think the group will benefit more by this means than by attempting to manage it directly. By taxation, regulation, and even by confiscation in emergencies, we demonstrate the superior claims of group interests over those of the individual. By group interests here we mean to include not only the narrow interests of corporate security holders and managers but those of consumers and wage earners as well.

As long as industry was organized on a small scale, such as a one-family farm, rewards for efficient management took the form of profits. Punishments for inefficiency of management became losses. Only the entrepreneur and his family suffered from the effects of his inefficiency. If this persisted, he finally lost control of his capital, and society sanctioned its transfer to another.

**Responsibility of Management.**—Under modern conditions of interdependence of individuals and groups in the struggle for a livelihood, losses are not adequate penalties for management inefficiency, for so many others, without fault of their own, are asked to bear the burdens of the mistakes of management. As soon as we realize how far the welfare and happiness of many individuals depend upon the will of one man, or of a small group of men entrusted with the management of a large corporation, we must of necessity question not only the honesty and good intentions of the management but also its capacity to perform the tasks assigned to it. As industrial organization becomes more and more complex, it will not be sufficient for corporate managers to present evidence that they possess average ability and integrity or that they will give to the affairs of the corporations they serve the time and attention that would be offered by the average man entrusted with corporate management. Most failures today are not the result of outright fraud and neglect. They follow the selection of managers who possess average integrity and ability and give average attention to the corporation's affairs. If the job calls for extraordinary ability, time, and attention, only men capable of meeting these demands should be given consideration.

**The Corporation's Birthright.**—All who engage in corporate promotions and in corporate management should be reminded from time to time of the heritage of their business enterprises. The privileges that are granted to them are not expected to be used as vehicles for exploitation. It is assumed that, when the public grants a charter to a corporation, the public anticipates that its interests will be protected. The first corporate charters were looked upon only as privileges, to be made the subject of a bargain between the

recipient and the sovereign power that granted them. When the English king of the seventeenth century made a deal with the incorporators of a trading company, he became a party to the exploitation of the enterprise and shared the loot with the promoters and the managers. In a modern democracy, the sovereign power that grants corporate charters is the mass of the people, generally classed as the public—made up of investors, consumers, wage earners, etc.

The older concept of a "special privilege" in the form of a corporate charter has given way to the current conception of the "right" of all citizens to access to the advantages of corporation codes. But in payment for this right, its users are expected to render a service that justifies the grant of the charter. Commodore Vanderbilt might not approve the substitution of "the public be served" for his famous expletive "the public be damned." Yet more and more the test of corporate sanctions is bound to become the kind of service that the various segments of the public receive from our business enterprises. Business statesmen recognize this fact and adjust their operations to it. Others must expect to take the consequences for their failure to read and abide by the signs of the times.

**The Function of Finance.**—All who take advantage of the laws which facilitate the organization of business enterprises need to remember that finance is a means and not an end. It is difficult for practically minded people to understand the recommendation that is sometimes made to the effect that goods should be produced for use and not for profit. The two are not incompatible. What is needed is to make sure that profit is allowed only for contributions made by the producers and the distributors of goods and services. More often than not, the sharpest criticisms directed against business methods are aimed at activities that result only in a financing profit which is not the result of commensurate service to production and distribution economics. But indiscriminating critics fail to recognize the target at which they direct their criticisms and blame businessmen and business methods as a whole for the actions of financial exploiters. Not only critics of business but business leaders themselves are interested in these attempts to make a financial profit at the expense of the public. For if the criticisms receive sufficient support, they will result in embarrassment to legitimate business operations in the effort to eliminate undesirable practices. Since business generally is blamed for the sins of mere exploiters, punishment is likely to be meted out to those who receive the blame, whether they deserve it or not.

**The Postwar World.**—With the victory of our military forces and those of our allies over the aggressor nations, the need for the continuance of democratic processes in business finance will be apparent. It is highly probable that we shall have more democracy in business finance in the future than we have had in the past. This does not necessarily mean that the various public groups will be any more effective in protecting their interests

by voluntary action than they have been heretofore. It might mean instead that their chosen representatives will be more alert and indeed more representative than some of their predecessors have been. It is unlikely that the changes made during the decade of the 1930's will be wiped out after the Second World War. Rather it seems more likely that so-called social control will be more far-reaching than it is at present. As governmental agents acquire experience, let us hope they add to their knowledge of business processes and acquire greater wisdom in regulating them.

### QUESTIONS AND SUGGESTIONS

1. Under what circumstances do people most want security? How important is this idea in your own thinking?
2. What do you understand by stabilization? Why is this term confused in public discussions?
3. How many economic plans have been offered for the solution of our problems?
4. What were the characteristics of the unstabilized past? What would be the probable effects of a stable economy?
5. What alternatives do we face in looking toward the future? Which do you favor and why?
6. Who is the economic man? Do you belong to his family? Explain.
7. Is fraud a new problem? What should be done about it?
8. Can all economic problems be solved by education? Why? Can they all be solved by government regulation? Why?
9. What are the essential characteristics of government regulation of business procedures?
10. What are the other agencies for social control? Is it proper to class the Investment Bankers Association of America as an agency of social control? Why?
11. In what way may courts be so classed? What is the chief weakness of depending upon courts to solve our economic problems?
12. What should be the objectives of business organization?
13. What is your idea of the justification for private ownership of property?
14. What problems do we face in attempting to place more responsibility upon corporate management?
15. What is meant by the corporation's birthright?
16. What is the major function of business finance?
17. What do you think are the major corporation problems of the immediate future?

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### SUBJECTS FOR INVESTIGATION

1. An editorial in a metropolitan newspaper contained the following quotation:

"The rapid development and adoption of machinery have brought what is commonly called overproduction, so that machinery and overproduction are two causes so closely allied that it is quite difficult to distinguish the one without taking the other into consideration. . . .

"The nations of the world have overstocked themselves with machinery and manufacturing plants far in excess of the wants of production. On all sides one sees the accomplished results of the labor of half a century. . . .

"It is true that the discovery of new processes of manufacture will undoubtedly continue and this will act as an ameliorating influence, but it will not leave room for marked extension, such as has been witnessed during the last fifty years, or afford employment to the vast amount of capital which has been created during that period. The day of large profits is probably past."

Do you agree with this quotation? Why?

2. If you had lived in 1886, when the above quotation first appeared in the first annual report of the United States commissioner of labor, would you have believed it then?

3. From what you have learned from your text, from your instructor, from other students, from your own researches, and above all from your own thinking about what you have heard and read, summarize the gains you have enjoyed from taking this course. Point your summary toward such questions as, What have I learned that will help me to become a more useful citizen? A better conservator of my resources? And a more efficient business leader?

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